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American Institute of Certified Public Accountants. Financial Forecasts and Projections Task Force

AICPA
American Institute of Certified Public Accountants

GUIDE FOR PROSPECTIVE FINANCIAL STATEMENTS

PREPARED BY THE FINANCIAL FORECASTS AND PROJECTIONS TASK FORCE

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NOTICE TO READERS

This guide presents the recommendations of the Financial Forecasts and Projections Task Force regarding accountants' services on prospective financial statements. It represents the considered opinion of the task force on the best practice for such engagements and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing standards. AICPA members may have to justify departure from the recommendations contained in this guide if their work is challenged.

The guide also includes descriptions and recommendations regarding presentation and disclosure of prospective financial statements. Although this guide does not have the authority of a pronouncement enforceable under rule 203 of the AICPA Code of Professional Ethics, it is intended to be helpful in determining whether prospective financial statements are presented in conformity with AICPA presentation guidelines. SAS No. 5, *The Meaning of "Presents Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, identifies AICPA guides as sources of established accounting principles that an AICPA member should consider.

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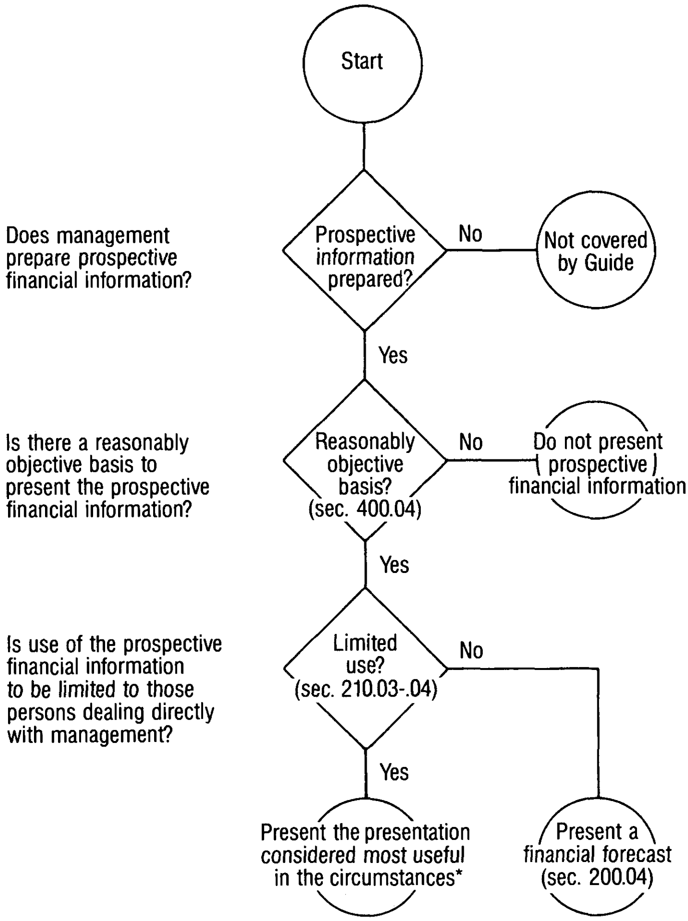


*Presentation could be a financial forecast (sec. 200.04), financial projection (sec. 200.05), or a partial presentation (sec. 200.06). Partial presentations are not covered by the Guide; however, see sec. 1000.

GUIDE FOR PROSPECTIVE FINANCIAL STATEMENTS
FLOWCHART OF ACCOUNTANTS' SERVICES

Is prospective information a full presentation?

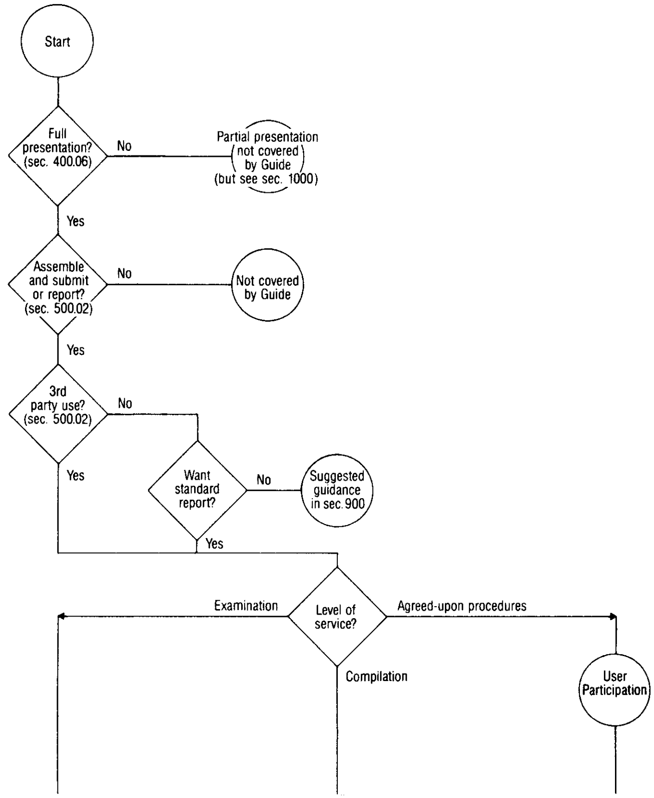
Does the accountant assemble and submit statements or report on them?

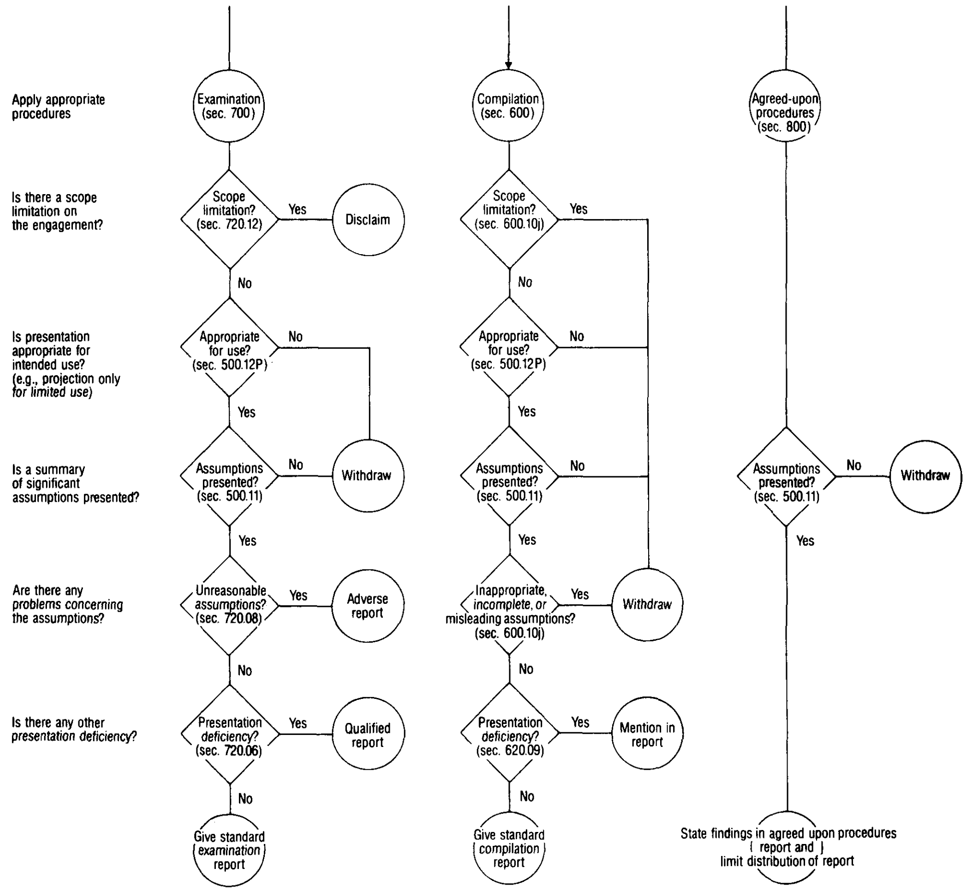
Is there a reasonable possibility of third-party use?

Does responsible party want a standard examination, compilation, or agreed-upon procedures report?

What level of service is accountant engaged to perform?

Have users participate in determining procedures





Apply appropriate procedures
Is there a scope limitation on the engagement?
Is presentation appropriate for intended use? (e.g., projection only for limited use)
Is a summary of significant assumptions presented?
Are there any problems concerning the assumptions?
Is there any other presentation deficiency?
Examination (sec. 700)
Scope limitation? (sec. 720.12)
Yes
Disclaim
No
Appropriate for use? (sec. 500.12P)
No
Withdraw
Yes
Assumptions presented? (sec. 500.11)
No
Yes
Unreasonable assumptions? (sec. 720.08)
Yes
Adverse report
No
Presentation deficiency? (sec. 720.06)
Yes
Qualified report
No
Give standard examination report
Compilation (sec. 600)
Scope limitation? (sec. 600.10j)
Yes
No
Appropriate for use? (sec. 500.12P)
No
Yes
Assumptions presented? (sec. 500.11)
No
Yes
Inappropriate, incomplete, or misleading assumptions? (sec. 600.10j)
Yes
Withdraw
No
Presentation deficiency? (sec. 620.09)
Yes
Mention in report
No
Give standard compilation report
Agreed-upon procedures (sec. 800)
Assumptions presented? (sec. 500.11)
No
Withdraw
Yes
State findings in agreed upon procedures report and limit distribution of report

General Information Regarding Prospective Financial Statements

Section 100

Introduction

.01 Prospective financial information is of interest to a broad spectrum of parties, including management, present or potential owners of equity interests, credit grantors and other informed third parties, government agencies, and the public.

.02 This guide was prepared to establish guidelines for the preparation and presentation of financial forecasts and projections (referred to as *prospective financial statements*). This guide is also intended to assist the accountant in performing professional services on, and reporting on, such statements.

.03 Prospective financial statements are based on assumptions regarding future events. The assumptions are, in turn, based on a combination of available information and judgment in which both history and plans play a part.

.04 Because no one can know the future, and because prospective financial statements may be affected by many factors internal and external to the entity, judgment must be used to estimate when and how conditions are likely to change. These judgments may subsequently prove to be unrepresentative of future conditions; thus, the achievability and reliability of prospective financial statements can never be guaranteed.

.05 Prospective financial information is less amenable to objective verification than historical data. When working with or using prospective information, it is essential to understand its inherent limitations.

Structure of the Guide

.06 Although the guide covers both financial forecasts and financial projections, its primary focus is on forecasts because they more closely parallel historical financial statements, which are intended to provide the financial information needed by persons making financial decisions who have access to neither the entity's financial records nor its management. Financial forecasts provide a framework for prospective reporting from which principles for financial projections are derived. Thus, the guide first presents the principles relating to financial forecasts and then shows how those principles are modified for financial projections.

.07 The guidance on financial forecasts contained in sections 300 through 900 generally also applies to financial projections. Certain paragraphs in those sections, however, do not apply—partially or fully—to projections. In those instances, readers interested in financial projections should refer to the corresponding *italicized* sections (which bear the same section number followed by a P) and consider the modifications discussed in those sections in conjunction with the paragraphs that precede them.

Relationship to Other Literature

.08 The AICPA has published four documents containing guidance on financial forecasts that are superseded by this guide: *Guidelines for Systems for the Preparation of Financial Forecasts*, Management Advisory Services Guideline No. 3 (March 1975), issued by the Management Advisory Services Division; *Presentation and Disclosure of Financial Forecasts*, Statement of Position 75–4 (August 1975), issued by the Accounting Standards Division; and *Guide for a Review of a Financial Forecast* (October 1980) and a Statement of Position, entitled *Report on a Financial Feasibility Study* (October 1982), prepared by the Financial Forecasts and Projections Task Force.

.09 In October 1985, the Auditing Standards Board issued, under rule 201 of the AICPA Code of Professional Ethics, a Statement on Standards for Accountants' Services on Prospective Financial Information, entitled *Financial Forecasts and Projections*. This guide incorporates in sections 500 through 820 the standards on accountants' services contained in that Statement. Accordingly, an accountant who complies with this guide will also be in compliance with the Statement. The guide also provides additional explanatory and illustrative material to aid the accountant in applying the Statement.

.10 The Securities and Exchange Commission permits the publication of prospective financial information under certain conditions and has adopted the general policy of encouraging such publication. The SEC has indicated that companies that include prospective financial information in SEC filings or annual reports should meet certain broad standards and disclosure requirements. In addition, the SEC adopted a rule that essentially provides a safe harbor for statements made by or on behalf of companies that issue prospective information or by an independent accountant unless such statements were (a) made other than in good faith or (b) disclosed without a reasonable basis. The SEC Policy on Projections, Guidelines for Disclosure of Projections of Future Economic Performance, and the Safe Harbor Rule for Projections are included as Appendixes A through C of this guide.

.11 The Department of the Treasury has issued regulations on tax shelter opinions. The regulations provide that when an accountant provides a "tax shelter opinion," he should, when possible, provide an opinion whether it is more likely than not that an investor will prevail on the merits of each material tax issue and an overall evaluation of the extent to which the material tax benefits are likely to be realized in the aggregate. Those regulations indicate that when an accountant provides services on a financial forecast or projection included in tax shelter offering materials he may be deemed to have issued a tax shelter opinion. The Treasury Department's regulations in Circular 230 are included as Appendix D of this guide.

Effective Date

.12 The presentation guidelines in this guide are effective for prospective financial statements prepared on or after September 30, 1986. The guidance on accountants' services is effective for engagements in which the date of completion of the accountants' services on prospective financial statements is September 30, 1986, or later. Earlier application is encouraged.

January 1986

Section 110

Scope

Presentations

.01 This guide deals with prospective financial statements.[1] These presentations may comprise prospective statements of financial position, results of operations, changes in financial position, and summaries of significant assumptions and significant accounting policies. These presentations may also be limited to those items discussed in section 400.06. A presentation that does not include the applicable minimum items in that section, including presentations limited to specified elements or accounts, is considered a partial presentation. Although this guide is not intended to provide comprehensive guidance regarding partial presentations, section 1000, "Partial Presentations," discusses certain matters regarding such information.

.02 Prospective financial information may be referred to by a number of different names, such as forecasts, projections, feasibility studies, break-even analyses, and budgets. Whatever such information is called, it is considered to be prospective financial statements if the presentation fits the description of prospective financial statements.

.03 Some financial presentations are designed to demonstrate the effect of a future or hypothetical transaction by showing how it might have affected the historical financial statements if it had been consummated during the period covered by those statements. These presentations are commonly called "pro forma financial statements." Although the transactions in question are prospective and such presentations may look like those described in the guide, the guide does not apply to those presentations because they are essentially historical statements and do not purport to be prospective financial statements.

1. See definition of prospective financial statements, section 200.03.

Accountants' Services

.04 Accountants are sometimes engaged for the expressed purpose of compiling, examining, or applying agreed-upon procedures to prospective financial statements. Often, however, they are engaged to assist their clients in other areas, for example, obtaining financing, deciding whether to lease or buy an asset, consummating a merger or acquisition, determining the tax consequences of future actions, or planning future operations; and in providing such services, they become involved with prospective financial statements. Regardless of the objective of the engagement, this guide covers the professional services that accountants may provide with respect to prospective financial statements for third-party use: compilation, examination, and application of agreed-upon procedures.

.05 Accountants may also be engaged to provide the types of services described in the preceding paragraph in connection with prospective financial statements for internal use only. Section 900 suggests procedures and reports on accountants' services on prospective financial statements that are restricted to internal use.

.06 The accountant may perform procedures to achieve the engagement's objectives that exceed the procedures discussed in this guide. For example, the guide is not intended to cover all aspects of performing financial feasibility studies, although such studies usually contain prospective financial statements. However, if an accountant provides a service on a feasibility study that includes prospective financial statements, then this guide applies to that service and resulting report. (Section 720.20 illustrates a report on an examination of a financial forecast contained in a feasibility study.)

.07 Accountants may be engaged to provide a variety of services relating to prospective financial information, such as providing assistance in developing forecasting systems and identifying factors to be considered in developing prospective financial statements. This guide is not intended to provide comprehensive guidance regarding such services.[2]

.08 An accountant who is engaged to perform services on partial

2. However, providing such services may, in some circumstances, subject the accountant to the provisions of this guide (see section 500).

presentations should refer to section 1000, "Partial Presentations," of this guide.

.09 Sometimes, accountants are associated with prospective financial statements that may be used in a pending or potential formal legal proceeding before a "trier of fact" in connection with the resolution of a dispute between two or more parties. These services are often called "litigation support services."

.10 This guide does not apply to engagements involving prospective financial statements used solely in connection with litigation support services, although it provides helpful guidance for many aspects of such engagements. However, the provisions of this guide are applicable if the prospective financial statements are used by third parties who do not have the opportunity to subject the accountant's work to detailed analysis and challenge (see section 500.03).

.11 The accountant who performs services on prospective financial information that are not covered by this guide should refer to rule 201(e) of the AICPA Code of Professional Ethics (see section 1000.05).

Section 200

Definitions

.01 Certain terms are defined as follows for the purposes of this guide.

.02 *Prospective financial information.* Any financial information about the future. The information may be presented as complete financial statements or limited to one or more elements, items, or accounts.

.03 *Prospective financial statements.* Prospective financial information that presents financial position, results of operations, and changes in financial position. They are either financial forecasts or financial projections including the summaries of significant assumptions and accounting policies. Although prospective financial statements may cover a period that has partially expired, statements for periods that have completely expired are not considered to be prospective financial statements. Pro forma financial statements[1] and partial presentations are not considered to be prospective financial statements.

.04 *Financial forecast.* Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and changes in financial position. A financial forecast is based on the responsible party's assumptions reflecting conditions it expects to exist and the course of action it expects to take. A financial forecast may be expressed in specific monetary amounts as a single-point estimate of forecasted results or as a range, where the responsible party selects key assumptions to form a range within which it reasonably expects, to the best of its knowledge and belief, the item or items subject to the assumptions to actually fall. When a forecast contains a range, the range is not selected in a biased or misleading manner, for example, a range in which one end is significantly less expected than the other. Minimum presentation guidelines for a financial forecast are set forth in section 400.06.

1. See section 110.03 for a description of pro forma financial statements.

.05 *Financial projection.* Prospective financial statements that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and changes in financial position. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation, as in response to a question such as "What would happen if. . . ?" A financial projection is based on the responsible party's assumptions reflecting conditions it expects would exist and the course of action it expects would be taken, given one or more hypothetical assumptions. A projection, like a forecast, may contain a range. Minimum presentation guidelines for a financial projection are set forth in section 400.06.

.06 *Partial presentation.* A presentation of prospective financial information that excludes one or more of the applicable items required of prospective financial statements set forth in section 400.06.

.07 *Entity.* Any unit, existing or to be formed, for which financial statements could be prepared in accordance with generally accepted accounting principles or another comprehensive basis of accounting.[2] For example, an entity can be an individual, partnership, corporation, trust, estate, association, or governmental unit.

.08 *Hypothetical assumption.* An assumption used in a financial projection to present a condition or course of action that is not necessarily expected to occur, but is consistent with the purpose of the projection.

.09 *Responsible party.* The person or persons who are responsible for the assumptions underlying the prospective financial statements. The responsible party usually is management, but it can be persons outside of the entity who do not currently have the authority to direct operations (for example, a party considering acquiring the entity).[3]

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2. Statement on Auditing Standards (SAS) No. 14, *Special Reports*, discusses comprehensive bases of accounting other than generally accepted accounting principles.
3. See section 220.

.10 *Management.* Those persons who are expected to direct the operations of the entity during the prospective period. Management typically refers to those persons at the highest level of authority within the entity.[4]

.11 *Key factors.* The significant matters on which an entity's future results are expected to depend. Such factors are basic to the entity's operations and thus encompass matters that affect, among other things, the entity's sales, production, service, and financing activities. Key factors serve as a foundation for prospective financial statements and are the bases for the assumptions.

.12 *General use.* Use of prospective financial statements by persons with whom the responsible party is *not* negotiating directly.

.13 *Limited use.* Use of prospective financial statements by the responsible party alone or by persons with whom the responsible party *is* negotiating directly.

.14 *Examination of prospective financial statements.* A professional service that involves (1) evaluation of the preparation of the prospective financial statements, the support underlying the assumptions, and the presentation of the prospective financial statements for conformity with AICPA presentation guidelines, and (2) issuance of an examination report.

.15 *Compilation of prospective financial statements.* A professional service that involves assembly, to the extent necessary, of prospective financial statements; consideration of whether the assumptions or presentation are obviously inappropriate; and issuance of a compilation report in which the accountant expresses no conclusion or any other assurance.

.16 *Assembly.* The manual or computer processing of mathematical or other clerical functions related to the presentation of the prospective financial statements. Assembly does not refer to the mere reproduction and collation of such statements or to the responsible party's use of the accountant's computer processing hardware or software.

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4. If the entity is to be formed in the future, the term "management" includes the promoters or other individuals who expect to be responsible for directing the operations of the entity.

Section 210

Types of Prospective Financial Statements and Their Uses

.01 Entities prepare prospective financial statements for a variety of reasons. For example, an entity may want to obtain external financing, consider a change in operations or accounting, or prepare a budget. The reason the prospective financial statements are prepared determines the type of prospective statements developed.

.02 Prospective financial statements are for either "general use" or "limited use." This section discusses the differences between the two uses and the types of presentations that are appropriate for those uses.

.03 "General use" of prospective financial statements refers to use of the statements by persons with whom the responsible party is not negotiating directly, for example, in an offering statement of an entity's debt or equity interests. Because recipients of prospective financial statements distributed for general use are unable to ask the responsible party directly about the presentation, the presentation most useful to them is one that portrays, to the best of the responsible party's knowledge and belief, the expected results. Thus, only a financial forecast is appropriate for general use.

.04 "Limited use" of prospective financial statements refers to use of prospective financial statements by the responsible party alone or by the responsible party and third parties with whom the responsible party is negotiating directly. Examples include use in negotiations for a bank loan, submission to a regulatory agency, and use solely within the entity. Third-party recipients of prospective financial statements intended for limited use can ask questions of the responsible party and negotiate terms directly with such party. Any type of prospective financial statement that would be useful in the circumstances would normally be appropriate for limited use. Thus, the presentation may be a financial forecast or a financial projection.

.05 Because a financial projection is not appropriate for general use, it should not be distributed to those who will not be negotiating directly with the responsible party, for example, in an offering statement of an entity's debt or equity interests, unless the projection is used to supplement a financial forecast and is for a period covered by the forecast.

.06 The classification of prospective financial statement use as either "general" or "limited" is not dependent on the number of users. Rather, the use is considered limited if each of the users negotiates directly with the responsible party; the use is considered to be general if the users do not. Thus, prospective financial statements to be used by even one passive user would be considered general use while use by a number of persons who all negotiate directly with the responsible party would be considered limited use.

.07 The responsible party should have a reasonably objective basis to present a financial forecast for it to be appropriate for general use. The responsible party has a reasonably objective basis to present a forecast if sufficiently objective assumptions can be developed for each key factor. In some instances, the nature of one or more assumptions may be so subjective that the responsible party could have no reasonably objective basis to present a forecast (see section 400.04). In that case, the responsible party generally should not present prospective financial statements for general use.

.08 If the responsible party does not have a reasonably objective basis for one or more assumptions, it may nonetheless be able to present prospective financial information for limited use. For example, it might be appropriate for the responsible party to (1) establish hypothetical assumptions that have no reasonably objective basis and present a financial projection (see section 400.04P) or (2) present a partial presentation (see section 1000) that omits the element, item, or account that does not have a reasonably objective basis.

Section 220

Responsibility for Prospective Financial Statements

.01 Prospective financial statements, including the underlying assumptions, are the responsibility of the entity's "responsible party."[1] The responsible party cannot guarantee the achievement of the financial results set forth in the prospective financial statements because achievability depends on many factors that are outside of its control. However, the responsible party may influence the operations of an entity through planning, organizing, controlling, and directing its activities and, therefore, is in a position to develop reasonable or appropriate assumptions in respect to key factors.

.02 The responsible party may enlist the assistance of outside parties in preparing prospective financial statements. For example, an accountant may provide such assistance by helping the responsible party identify key factors, develop assumptions, gather information, or assemble the statements. The accountant may also be engaged to develop a financial model so that the responsible party or others may consider the results using a variety of assumptions. Such activities ordinarily would not affect the accountant's objectivity in examining the prospective financial statements.[2]

.03 Regardless of the extent of the accountant's participation, the assumptions remain the responsibility of the responsible party. The accountant may assist in the formulation of assumptions, but the responsible party must evaluate the assumptions, make key decisions, and adopt and present the assumptions as its own.

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1. See the definition of "responsible party" in section 200.09.

2. Some of these services may not be appropriate if the accountant is to be named as a reviewer in a filing with the SEC. SEC Release Nos. 33–5992 and 34–15305, "Disclosure of Projections of Future Economic Performance," state that, for prospective financial statements filed with the Commission, "a person should not be named as an outside reviewer if he actively assisted in the preparation of the projection." (These releases were issued before AICPA standards for services on prospective financial information, which define the three levels of accountants' services described in this guide. Thus, the SEC's terminology does not correspond to that used in this guide.)

.04 Since the accountant does not take responsibility for the assumptions, his services with respect to an entity's prospective financial statements would not, per se, affect his independence with regard to services on its historical financial statements.

.05 Occasionally, an accountant may be engaged to prepare a financial analysis of a potential project where the engagement includes obtaining the information, making appropriate assumptions, and assembling the presentation. Such an analysis is not, and should not be characterized as, prospective financial statements and would not be appropriate for general use unless the responsible party reviewed and adopted the assumptions and presentation (see section 500.13).

Guidance for Entities That Issue Prospective Financial Statements

Section 300

Preparation Guidelines

Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. *Italicized* paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term "forecast."

.01 This section provides guidance to the responsible party for preparing financial forecasts. These guidelines are applicable generally, but the organizational and procedural means of applying them may differ from case to case because of the circumstances involved.

.02 An entity can prepare financial forecasts without adhering to all the guidelines in this section. Using a process that incorporates these guidelines, however, often results in the development of more reliable prospective data than preparing financial forecasts without such a process. In addition to providing better management data, the use of such a process facilitates an independent accountant's examination of the resulting financial forecasts.

.03 A process for preparing financial forecasts may be any of the following:

a. A formal system
b. Performance of a work program that outlines the steps followed in preparation
c. Documented procedures, methods, and practices used in preparation

The type of process used in preparing financial forecasts normally depends on the circumstances. In some cases the complexity of the data involved or regular use of the process may require a formal system. In many cases, however, the cost of a formal system exceeds the benefits derived from it, and an entity can satisfactorily prepare financial forecasts using either of the other processes. The three types of processes are discussed in the following paragraphs.

.04 Financial forecasts may be prepared as the output of a formal system. A formal system consists of a set of policies, procedures, methods, and practices systematically applied by qualified personnel. It embraces inputs, processing, and outputs of the system and includes the collection, recording, analysis, interpretation, processing, and review of information concerning all elements of the enterprise.

.05 A formal system also consists of a set of related policies, procedures, methods, and practices that are used to prepare financial forecasts, monitor attained results relative to the forecasts, and prepare revisions or otherwise update the forecasts.

.06 Financial forecasts may also be prepared without a formal system. A formal work program outlining the steps followed in the preparation of the financial forecasts (which may be refined as work progresses) or a documentation of procedures, methods, and practices used in preparation may take the place of a formal system and still conform to these guidelines. If a work program is used, it should provide for adequate definition of the procedures, methods, and practices to be employed.

.07 The guidelines in this section represent the elements that ideally would be included in a process to develop financial forecasts. However, the guidelines would not need to be applied to immaterial items.

.08 The following is a summary of the guidelines for preparation of financial forecasts. These guidelines are discussed in the following sections:

Section	Guideline
310	Financial forecasts should be prepared in good faith.
311	Financial forecasts should be prepared with appropriate care by qualified personnel.
312	Financial forecasts should be prepared using appropriate accounting principles.
313	The process used to develop financial forecasts should provide for seeking out the best information that is reasonably available at the time.

Section	Guideline
314	The information used in preparing financial forecasts should be consistent with the plans of the entity.
315	Key factors should be identified as a basis for assumptions.
316	Assumptions used in preparing financial forecasts should be appropriate.
317	The process used to develop financial forecasts should provide the means to determine the relative effect of variations in the major underlying assumptions.
318	The process used to develop financial forecasts should provide adequate documentation of both the financial forecasts and the process used to develop them.
319	The process used to develop financial forecasts should include, where appropriate, the regular comparison of the financial forecasts with attained results.
320	The process used to prepare financial forecasts should include adequate review and approval by the responsible party at the appropriate levels of authority.

310 Financial forecasts should be prepared in good faith.

.01 The potential to mislead a third-party reader of financial forecasts is greater than that for historical financial statements. Preparation of financial forecasts necessitates the use of judgment, and the responsible party should make a good-faith effort in preparing such statements. Good faith in this context includes making a diligent effort to develop appropriate assumptions (see sections 313 through 317). Good faith also includes exercising care not to mislead a third-party reader. Accordingly, financial forecasts should be presented in conformity with the presentation guidelines in section 400 of this guide, including appropriate disclosures.

.02 Because a financial forecast reflects the responsible party's estimate of financial results based on its plans, good faith precludes preparing it with either undue optimism or pessimism.

.02P Although a financial forecast prepared in good faith is neither unduly optimistic nor pessimistic, the purpose of a financial

projection may require optimism or pessimism. For example, a break-even analysis may be prepared by a real estate developer who expects to realize income. Accordingly, the hypothetical assumptions used in a financial projection should be consistent with the purpose of the projection; the other assumptions, including assumed courses of action, should be consistent with events expected to occur given the hypothetical assumptions.

311 Financial forecasts should be prepared with appropriate care by qualified personnel.

.01 "Appropriate care" means that diligence and proper attention should be exercised in the preparation of the financial forecasts.

.02 The preparation of financial forecasts ordinarily involves the use of large amounts of data and requires a great many calculations. These data may be processed without the benefit of the checks and balances inherent in a historical accounting system, which makes the preparation of financial forecasts particularly susceptible to clerical error. Procedures should be established to facilitate the prevention, detection, and correction of such errors.

.03 The use of qualified personnel ensures that appropriate knowledge and competence are present or are acquired while developing the financial forecasts. Personnel having competence in marketing, operations, finance, research and engineering, and other technical areas as appropriate under the circumstances should participate in the development of the financial forecasts.

.04 Analytical capability and expertise may be needed to analyze and interpret relevant historical data. In some circumstances, expertise in technical forecasting techniques and methods may be required.

312 Financial forecasts should be prepared using appropriate accounting principles.

.01 The accounting treatment applied to events and transactions contemplated in financial forecasts should be the same as the accounting treatment expected to be applied in recording the events when or if they occur.

.02 Occasionally, a different basis of accounting is used in a financial forecast than is to be used for historical financial statements. For example, a cash-basis statement may be prepared to determine cash flow. In these situations the process used to develop the financial forecast should provide a means for reconciling the prospective results with those that would be obtained using the basis of accounting used in historical financial statements.

.03 From time to time entities change the accounting principles they use. Such changes should be reflected in financial forecasts as they would be in historical financial statements. (APB Opinion No. 20, *Accounting Changes*, states that there is a presumption in preparing financial statements that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type. That presumption may be overcome only if the entity can justify the use of an alternative acceptable accounting principle on the basis that it is preferable.)

.04 Because a financial forecast reflects an estimate of the entity's expected results, an accounting change should be reflected in the forecast only if the responsible party expects to make the change in the historical statements.

> ***.04P*** *There are instances in which changes in accounting principles reflected in financial projections need not be expected to occur in the historical financial statements. For example, a projection may be prepared for the purpose of estimating an entity's financial results based on a change in the method by which inventories are valued. These may be prepared for analytical purposes with no intention of actually changing the method of inventory valuation.*

.05 When such changes in accounting treatment are contemplated, the process used to develop financial forecasts should include a means to reconcile the prospective results with those that would be obtained by using the accounting principles used in prior historical financial statements.

313 The process used to develop financial forecasts should provide for seeking out the best information that is reasonably available at the time.

.01 Information relevant to financial forecasts comes from many sources, both within and outside an entity. An effective process to develop financial forecasts should provide for searching out the best information that is reasonably available relevant to developing assumptions that are appropriate in relation to the presentation.

The information used would include any relevant historical information.

.01P Although this guideline applies to financial projections, it need not be applied to hypothetical assumptions selected to analyze alternative courses of action. However, the assumptions other than the hypothetical ones should be developed by the responsible party using the best information reasonably available at the time, given the hypothetical assumptions. For example, a financial projection might show results using several sales prices for the entity's product. The assumptions relating to semivariable costs (for example, commissions) should be developed based on the best information reasonably available for each sales price and should be consistent with the expected course of action at each sales price.

.02 The acquisition of information ordinarily involves a cost. This cost should be commensurate with the anticipated benefits to be derived from the information. For example, the cost of making a survey may far exceed any potential benefit, even though the survey might provide the most precise information available. This section does not intend that information be acquired regardless of cost, although cost alone is not sufficient reason not to acquire needed information.

.03 Financial forecasts can be based only on information reasonably available at the time they are prepared. Often, pertinent information becomes available only after financial forecasts have been completed or disclosed or after the prospective period has expired. The fact that information existed does not necessarily mean that it was available to the preparers of the financial forecasts.

.04 Various sources of information involve different degrees of reliability. The reliability of the basic data should be considered in the process of preparing the financial forecasts.

.05 A key consideration in the preparation of financial forecasts is the use of an appropriate level of detail. In certain situations the use of more detail may improve the reliability of financial forecasts. For example, forecasting sales by product line rather than in the aggregate may improve the forecast of sales, especially when the products sold are in different markets.

.06 However, situations also exist where the use of less detail or a more aggregated approach may improve reliability. For example, forecasting the cost for a common component contained in various product lines may be determined more effectively by grouping the product lines to ascertain the total quantity of the substance expected to be used.

314 The information used in preparing financial forecasts should be consistent with the plans of the entity.

.01 Financial forecasts should be consistent with the expected economic effects of anticipated strategies, programs, and actions, including those being planned in response to expected future conditions.

.01P Financial projections need not necessarily be consistent with the plans of the responsible party but, instead, may represent alternatives based on a special purpose contemplated in preparing the presentation. The alternatives should reflect the responsible party's expected actions given the actual occurrence of the hypothetical event. For example, a manufacturing company that does not lay off workers during slow periods should not treat labor as a variable expense if the hypothetical event is a temporary reduction in production levels. The presentation should reflect the course of action consistent with its purpose.

.02 An indication of the responsible party's plans can often be found in its budgets, goals, and policies. These sources of information should be considered in the preparation of financial forecasts. In considering these sources of information it should be determined if they are unduly optimistic or pessimistic, and if they are, that fact should be taken into account when preparing financial forecasts. Plans and budgets are more reliable and credible when developed through the use of effective planning and control systems. Sound, timely reporting by functional responsibility together with effective planning and budgeting form the foundation of a process that develops financial forecasts.

315 Key factors should be identified as a basis for assumptions.

.01 Key factors are those significant matters upon which an entity's future results are expected to depend. These factors are basic to the entity's operations and serve as the foundation for the prospective financial statements. Key factors vary by entity and industry.

.02 All key factors should be identified in preparing financial forecasts. After such identification, assumptions should be developed for those key factors. For example, if a key factor is manufacturing labor, assumptions might be developed regarding manpower requirements and labor rates.

316 Assumptions used in preparing financial forecasts should be appropriate.

.01 Assumptions are the essence of developing financial forecasts and are the single most important determinant of such statements. The quality of the underlying assumptions largely determines the quality of financial forecasts.

.02 The attention devoted to the appropriateness of a particular assumption should be commensurate with the likely relative impact of that assumption on the prospective results. Assumptions with greater impact should receive more attention than those with less impact.

.03 The assumptions should be reasonable and suitably supported. The level of support should be persuasive, although there are times when a number of assumptions in a narrow range of possibilities may appear equally likely.

> ***.03P*** *Hypothetical assumptions need not be reasonable but should be appropriate in light of the purpose for which the financial projection is prepared. All other assumptions should be reasonable given the hypothetical assumptions and be consistent with the hypothetical assumptions and each other. That is, the other assumptions should be developed to depict conditions based on the hypothetical assumptions. For example, if a financial projection is prepared to show the effect of the construction of a new production facility that is partially financed, the presentation should include the effect of the related debt service. Further, hypothetical assumptions need not be supported, as they relate to the special purpose of the presentation. The other assumptions, however, should be suitably supported given the hypothetical assumptions.*

.04 The nature of a business enterprise is such that many underlying assumptions are interrelated, and certain of their elements may have multiple effects. For example, a slowdown in economic activity typically will not only cause a slowdown in sales volume, but may also affect prices and the availability and cost of resources. The conditions assumed in arriving at the prospective sales or revenue data should be consistent with those assumed in developing the prospective financial data for cost of operations. Care should be exercised to ensure that appropriate costs and revenues have been considered, that sufficient capacity and resources would be available to produce the forecasted revenues, that capital expenditures have been recognized as appropriate, that provision has been made for applicable taxes, and that the need for financing has been considered.

.05 Support for assumptions might include market surveys; general economic indicators; trends and patterns developed from the entity's operating history, such as historical sales trends; and internal data and analyses, such as obligations under union contracts for labor rates.

.06 In analyzing alternative assumptions, care should be exercised to assess the situation objectively. Relating assumptions to past or present conditions often is a useful approach for checking reasonableness or appropriateness; however, trends are not necessarily reliable indicators of the future. Particular attention should be given to the possibility of changes in conditions, which must rest mainly on theory and on an understanding of the basic causal factors.

.07 It is ordinarily not feasible to exhaustively document and support all the assumptions underlying financial forecasts. It is nevertheless necessary to seek out and explicitly identify information that forms a basis for the most significant assumptions; although frequently the most basic assumptions with enormous potential impact, such as those relating to war or peace conditions, are not addressed explicitly. Despite precautions, hindsight will often reveal assumptions that have been overlooked or that, in the light of later circumstances, received inadequate treatment. Further, the nature of developing financial forecasts is such that some assumptions may not materialize and unanticipated events and circumstances may occur no matter what effort, analysis, or support may be applied.

317 The process used to develop financial forecasts should provide the means to determine the relative effect of variations in the major underlying assumptions.

.01 Prospective financial results are relatively more sensitive to certain assumptions and less sensitive to others. Small changes in certain assumed conditions can result in relatively large variations in the prospective results, while relatively large changes in other assumptions cause only minor shifts in the prospective results.

.02 In developing financial forecasts, an understanding of the relative sensitivity of the results to the assumed conditions permits the allocation of analysis and study, as well as review by persons of higher authority, to those areas with the most significant effect. Particular attention should be devoted to those assumptions (1) to which the attainment of forecasted results is particularly sensitive (that is, those in which a small variation in the assumption would have a large effect on forecasted results) and (2) for which the probability of variation is high.

318 <u>The process used to develop financial forecasts should provide adequate documentation of both the financial forecasts and the process used to develop them.</u>

.01 Documentation makes possible review and approval of financial forecasts by the responsible party. It facilitates comparison of the financial forecasts with actual financial results, and it provides the discipline necessary for developing reliable financial forecasts. Documentation enables the responsible party to analyze the key factors on which its assumptions were based, thereby allowing for identification of changes in these factors and their anticipated effects on a timely basis.

.02 Documentation involves recording the underlying assumptions as well as summarizing the supporting evidence for the assumptions. Documentation provides the ability to trace forecasted results back to the support for the basic underlying assumptions.

.03 Adequate documentation makes it possible for persons experienced and qualified in developing financial forecasts to reconstruct the financial forecasts. Documentation covers the process, as well as individual financial forecasts, and provides an organized record of both that can be maintained and made available for subsequent use.

319 <u>The process used to develop financial forecasts should include, where appropriate, the regular comparison of the financial forecasts with attained results.</u>

.01 The objective of financial forecasts is to estimate financial results for one or more future periods under expected conditions. Comparison of prospective financial results with actual results for the prospective period and for prior periods for which financial forecasts were prepared provides a historical measure of success in developing financial forecasts and may also be useful as an indication of the likely reliability of future financial forecasts. Regular comparison with actual results and analysis of deviations also provide a basis for making improvements in the methods and approaches used in developing financial forecasts; however, if there is no intention to prepare financial forecasts in the future, there may be no need for such comparisons and analyses.

.02 If prospective results are compared to actual results, the comparison should not be limited to overall financial results but should also include comparison of the key factors and assumptions, such as sales volumes, prices, and production rates.

320 The process used to prepare financial forecasts should include adequate review and approval by the responsible party at the appropriate levels of authority.

.01 Financial forecasts are important statements of the future financial results of an entity. The ultimate responsibility for financial forecasts rests with the responsible party at the highest level of authority, the same level as for historical financial statements.

.02 Adequate review means that the review is conducted in sufficient depth to assure the responsible party of the soundness of the process used to develop the financial forecasts and that the financial forecasts and subsequent revisions were prepared in accordance with the guidelines for the preparation of financial forecasts. The responsible party should have access to the financial forecasts and supporting documentation to adequately review and approve the financial forecasts.

.03 Review by the responsible party at intermediate levels of authority, including such functions as marketing, operations, engineering, and finance, enables the financial forecasts to be evaluated from several vantage points by those who will be responsible for the subsequent operations.

Section 400

Presentation Guidelines

Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. *Italicized* paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term "forecast."

.01 This section provides presentation guidelines for entities that issue financial forecasts.

Uses of a Financial Forecast

.02 As explained in section 210, a financial forecast may be either for general use or for limited use. Because users of forecasts for general use may not have the opportunity to negotiate directly with the responsible party, they are best served by a presentation that presents, to the best of the responsible party's knowledge and belief, its expected financial position, results of operations, and changes in financial position,[1] that is, a financial forecast.

> ***.02P** As explained in section 210, financial projections are limited-use presentations and thus should not be submitted to those who do not have the opportunity to negotiate directly with the responsible party.*

Responsibility for Financial Forecasts

.03 The responsibility for presentation of a financial forecast in conformity with these guidelines is analogous to that for the presentation of historical financial statements; that is, it is the responsibility of the "responsible party."[2] The responsible party may enlist the assistance of outside parties to meet these presentation guidelines.

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1. A financial forecast may be summarized or condensed. Section 400.06 describes the minimum items that constitute a forecast.
2. See definition of responsible party, section 200.09.

.04 The responsible party should consider whether it has a reasonably objective basis to present a financial forecast. In evaluating whether it has a reasonably objective basis, the responsible party should consider whether sufficiently objective assumptions can be developed for each key factor. In some instances, the nature of one or more assumptions may be so subjective that the responsible party could have no reasonably objective basis to present a financial forecast. For example, the responsible party might have no reasonably objective basis to present a forecast that includes royalty income from products not yet invented or revenue from a thoroughbred being reared to race. In such cases it would be inappropriate to present a forecast because of the lack of a reasonably objective basis.

> ***.04P*** *For a projection, the responsible party need not have a reasonably objective basis for the hypothetical assumptions, although, as noted in section 200.08, the hypothetical assumptions should be consistent with the purpose of the projection. In addition, the responsible party should consider that, as the hypothetical assumptions increase in number and/or significance, it may not be appropriate to present a projection.*

Title

.05 The title used for a financial forecast should describe the nature of the presentation and should include the word "forecast" or "forecasted."

> ***.05P*** *Statement titles in financial projections should be descriptive of the presentation. Accordingly, they should not imply that the presentation is a forecast. In addition, titles should describe or refer to any significant hypothetical assumptions. For example, a break-even analysis might be titled "Projected Results of Operations and Changes in Financial Position at Break-Even Sales Volume."*

Format

.06 Prospective information presented in the format of historical financial statements facilitates comparisons with financial position, results of operations, and changes in financial position of prior periods, as well as those actually achieved for the prospective period. Accordingly, financial forecasts preferably should be in the format of the historical financial statements that would be issued for the period(s) covered if there is no agreement between the responsible party and potential users specifying another format. Financial forecasts may take the form of complete basic financial statements[3] or may be limited to the following items (where such items would be presented for historical financial statements for the period):[4]

a. Sales or gross revenues
b. Gross profit or cost of sales
c. Unusual or infrequently occurring items
d. Provision for income taxes
e. Discontinued operations or extraordinary items
f. Income from continuing operations
g. Net income
h. Primary and fully diluted earnings per share
i. Significant changes in financial position[5]
j. A description of what the responsible party intends the financial forecast to present, a statement that the assumptions are based on the responsible party's judgment at the time the prospective information was prepared, and a caveat that the forecasted results may not be achieved
k. Summary of significant assumptions
l. Summary of significant accounting policies

.07 Items a through i, above, represent the minimum items that constitute a financial forecast. A presentation that omits one or more

3. The details of each statement may be summarized or condensed so that only the major items in each are presented. The usual footnotes associated with historical financial statements need not be included as such. However, significant assumptions and accounting policies should be disclosed.

4. Similar types of financial information should be presented for entities for which these terms do not describe operations, as illustrated in section 410.02. Further, similar items should be presented if a comprehensive basis of accounting other than generally accepted accounting principles is used to present the forecast. For example, if the forecast is presented on the cash basis, item a would be cash receipts. The basis of acounting on which the forecast is presented should be appropriate for the use of the forecast.

5. This item does not require a balance sheet or a statement of changes in financial position. Exhibits 2, 3, and 5 in section 410 illustrate alternative methods of presenting significant changes in financial position.

of these that are applicable[6] would be a partial presentation and, thus, would not ordinarily be appropriate for general use.[7] If the omitted applicable item is derivable from the information presented, the presentation would *not* be deemed to be a partial presentation.

.08 Items j through l, above, are disclosures that should accompany the forecast whether the presentation is limited to applicable minimum items or presents more detail. The omission of item j, k, or l from a presentation that contains at least the applicable minimum items would not make it a partial presentation; it would be a deficient presentation because of the lack of required disclosures.

.09 The guidelines for preparation of financial forecasts (section 300) apply even if the presentation is limited to the minimum items above. Therefore, the underlying data used in the preparation of financial forecasts should be sufficient to allow presentation of detailed statements even though only the minimum is to be presented.[8]

.10 Each page of a financial forecast should contain a statement that directs the reader to the summaries of significant assumptions and accounting policies.

Date

.11 The date of completion of the preparation of a financial forecast should be disclosed. The responsible party should be satisfied that the assumptions are appropriate as of this date even though the underlying information may have been accumulated over a period of time. Such a disclosure assists users in determining how current the presentation is and serves as a warning when such statements were

6. An applicable item is one that would be presented for historical financial statements. For example, earnings per share would not be an applicable item for a nonpublic entity since earnings per share are not required to be presented for historical financial statements for such entities.

7. See section 1000 for a discussion of partial presentations.

8. This level of detail should be comparable to that presented in historical financial statements.

prepared some time ago. Section 400.29 (the example introduction to the summary of significant assumptions) illustrates such a disclosure.

Accounting Principles and Policies

.12 A summary of significant accounting policies used in preparing the financial forecast should be disclosed. If a financial forecast is included in a document that contains certain of this information, disclosure can be accomplished by cross-referencing.

.13 Financial forecasts usually should be prepared on a basis consistent with the accounting principles expected to be used in the historical financial statements covering the prospective period (see section 312).

> ***.13P*** *Although ordinarily a financial projection should use the accounting principles expected to be used in the historical statements, sometimes the special purpose of the presentation requires it to be prepared based on other accounting principles. In such cases the use of different accounting principles should be disclosed. Differences in financial position and results of operations arising from the use of different accounting principles may be reconciled and disclosed. An example of such a disclosure follows.*
>
> *The projection assumes that inventory will be valued on the last-in, first-out method, whereas the company has historically used the first-in, first-out method. If the latter method were used in this projection, inventory and income before income taxes would be increased by \$XX, provision for income taxes would be increased and other working capital decreased by \$XX, and net income and shareholders' equity would be increased by \$XX.*

.14 When the historical financial statements for the prospective period are expected to be prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles, the financial forecast preferably should be prepared on that basis of accounting, and the specific information required to be presented should be adapted as appropriate for the basis of accounting used. The basis of accounting used should be disclosed along with the fact that the disclosed basis is different from generally accepted accounting principles.

.15 Ideally, prospective financial statements and historical financial statements should be available to users on the same basis of accounting. Occasionally, a different comprehensive basis of accounting is used for a financial forecast than is to be used for the historical financial statements for the prospective period. In such situations, use of a different basis should be disclosed, and differences in results of operations and changes in financial position resulting from the use of a different basis usually would be reconciled in the financial forecast. In some circumstances, such as certain tax shelters, a detailed reconciliation would not be useful. In such a case, a general description of the differences resulting from the use of different bases should be presented. Exhibit 5 in section 410 illustrates a reconciliation in the case of a cash-basis projection where the historical financial statements are expected to be prepared in conformity with generally accepted accounting principles.[9]

.16 If a financial forecast gives effect to a change in accounting principles from one used in prior-period historical financial statements, the change should be reported in the financial forecast for the period in which it is expected to be made, as would be required in reporting such an accounting change in historical financial statements.[10]

Materiality

.17 The concept of materiality applies to financial forecasts; thus, the provisions of this section need not be applied to immaterial items. Materiality is a concept that is judged in light of the expected range of reasonableness of the information, and therefore users should not expect prospective information (information about events that have not yet occurred) to be as precise as historical information.

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9. Although the example shown is a financial projection, the reconciliation in that example would be applicable to a financial forecast as well.

10. See APB Opinion No. 20, *Accounting Changes*, for guidance relevant to accounting for and disclosing changes in accounting principles (see section 312.03).

Presentation of Amounts

.18 Financial forecasts are normally expressed in specific monetary amounts as a single-point estimate of forecasted results, but also can be expressed as a range when the responsible party selects key assumptions to form a range within which it reasonably expects, to the best of its knowledge and belief, the item or items subject to the assumptions actually to fall. The tentative nature of financial forecasts would be emphasized if the amounts representing the key measures (for example, sales and interest expense) were supplemented by analysis of the sensitivity of the forecast to variations. When a forecast contains a range, the range should not be selected in a biased or misleading manner, for example, a range in which one end is significantly less expected than the other.

.19 When a forecast contains a range, the width of the range generally indicates the responsible party's relative uncertainty about the forecast. As the uncertainty surrounding the forecast increases, the range ordinarily would widen. However, the responsible party should consider that, as the range becomes too wide, the presentation may not be meaningful to users.

.20 Financial forecasts may be supplemented by financial projections (1) for the same period, to indicate differences in results of operations and financial position resulting from assumptions other than those expected to materialize (for example, different levels of sales volume or occupancy rates), or (2) for additional periods, in the case of limited-use presentations. If financial forecasts and projections are presented together, each should be clearly labeled.

.21 When a presentation that is other than a single-point estimate is issued, there should be a clear indication that the presentation does not necessarily represent the best or worst possible alternatives.

Assumptions

.22 The disclosure of significant assumptions is essential to the reader's understanding of the financial forecast; accordingly, the responsible party should disclose those assumptions deemed to be significant to the statements. The basis or rationale for the assumptions should preferably be disclosed to assist the user of the financial forecast to understand the presentation and make an informed judgment about it.

.23 Identifying those assumptions which, at the time of preparation, appear to be significant to the financial forecast requires the careful exercise of judgment by the responsible party. By nature, financial forecasts embody a large number of assumptions, especially for a complex enterprise, and an attempt to communicate all assumptions is inherently not feasible. Further, questions may arise after the fact regarding certain assumptions that were not disclosed, and unforeseen changes may make certain assumptions significant that previously were considered unimportant. The assumptions disclosed should include—

a. Assumptions about which there is a reasonable possibility of the occurrence of a variation that may significantly affect the prospective results; that is, sensitive assumptions.
b. Assumptions about anticipated conditions that are expected to be significantly different from current conditions, which are not otherwise reasonably apparent (see section 400.26).
c. Other matters deemed important to the prospective information or its interpretation.

.23P In addition to those assumptions discussed in section 400.23, the responsible party should identify which assumptions in the projection are hypothetical. In addition, if the hypothetical assumptions are improbable, the disclosure should indicate that.

.24 The presentation should indicate which assumptions disclosed appeared particularly sensitive at the time of preparation. Although the responsible party should try to identify particularly sensitive assumptions, hindsight may reveal sensitive assumptions that did not appear to be particularly sensitive earlier (see section 313.03).

.25 Particularly sensitive assumptions are those assumptions having a relatively high probability of variation that would materially affect the financial forecast. The impact on the financial forecast might result from either (a) an assumption with a relatively high probability of a sizable variation or (b) an assumption for which the probability of a sizable variation is not as high but for which a small variation would have a large impact. Not all significant assumptions are particularly sensitive. For example, an assumption regarding the federal income tax rate may be significant but not particularly sensitive, whereas the assumption about the interest rate of a new debt issue may be both significant and particularly sensitive. The disclosure of particularly sensitive assumptions need not include a quantification of the potential effects of variations in those assumptions. The illustrative prospective financial statements in section 410 include examples of disclosures of assumptions that are particularly sensitive.

.26 Frequently, a basic assumption that current conditions having enormous potential impact will continue to prevail is considered to be implicit in the financial forecast. Examples are conditions of peace, absence of natural disasters, and so on. Such assumptions need be disclosed only when there is a reasonable possibility that the current conditions will not prevail.

.27 Although all significant assumptions should be disclosed, they need not be presented in such a manner or in such detail as would adversely affect the competitive position of the entity.

.28 An introduction preceding the summary of assumptions should be provided to make clear that the assumptions disclosed are not an all-inclusive list of those used in the preparation of the prospective information and that they were based on the responsible party's judgment at the time the prospective information was prepared. The introduction should describe what the responsible party intends the financial forecast to present, should include a statement that the assumptions are based on the responsible party's judgment at the time the prospective information was prepared, and should include a caveat that the prospective results may not be attained.

.29 The introduction for a financial forecast that does not contain a range should be similar to the following.

> This financial forecast presents, to the best of management's[11] knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the forecast period. Accordingly, the forecast reflects its judgment as of [*date*], the date of this

11. If the responsible party is other than management, the reference to management in the introduction should be to the party who assumes responsibility for the assumptions.

forecast, of the expected conditions and its expected course of action. The assumptions disclosed herein are those that management believes are significant to the forecast. There will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.

.29P *The introduction preceding the summary of significant assumptions for a financial projection should, in addition, clearly explain any special purpose and limitation of the usefulness of the statements. For example, the introduction preceding the summary of assumptions for a presentation of results with sales at maximum productive capacity would be similar to the following. This example illustrates the introduction for a presentation with an improbable hypothetical assumption; the example should be modified as appropriate in the circumstances.*

> *This financial projection is based on sales volume at maximum productive capacity and presents, to the best of management's[12] knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the projection period if such sales volume were attained. Accordingly, the projection reflects its judgment as of* [date], *the date of this projection, of the expected conditions and its expected course of action if such sales volume were experienced. The presentation is designed to provide information to the Company's board of directors concerning the maximum profitability that might be achieved if current production were expanded through the addition of a third production shift and should not be considered to be a presentation of expected future results. Accordingly, this projection may not be useful for other purposes. The assumptions disclosed herein are those that management believes are significant to the projection. Management considers it highly unlikely that the stated sales volume will be experienced during the projection period. Further, even if the stated sales volume were attained, there will usually be differences between projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.*

.30 The following is an example of an introduction for a forecast that contains a range. In the situation illustrated the responsible party does not make a point estimate of occupancy of its apartment building but expects, to the best of its knowledge and belief, that

12. If the responsible party is other than management, this reference should be to the party who assumes responsibility for the assumptions.

actual occupancy will be between 75 and 95 percent of available apartments.

> This financial forecast presents, to the best of management's knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the forecast period at occupancy rates of 75 percent and 95 percent of available apartments. Accordingly, the forecast reflects its judgment as of [*date*], the date of this forecast, of the expected conditions and its expected course of action at each occupancy rate. The assumptions disclosed herein are those that management believes are significant to the forecast. Management reasonably expects, to the best of its knowledge and belief, that the actual occupancy rate achieved will be within the range shown; however, there can be no assurance that it will. Further, even if the actual occupancy rate is within the range shown, there will usually be differences between forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material, and the actual results may be outside the range presented by the forecast.

.31 Examples of disclosures of assumptions appear in the illustrative financial forecasts in section 410.

Period to Be Covered

.32 The responsible party should consider the needs of the users and its ability to estimate prospective results in determining the period to be covered. Ordinarily, to be meaningful to users, the presentation should include at least one full year of normal operations. For example, an entity forecasting a major acquisition would present at least the first full year following the acquisition and a newly formed entity would include at least the first full year of normal operations in addition to the start-up period. However, no fixed minimum or maximum period of time is specified in this guide.

.33 Although the degree of uncertainty generally increases with the time span, short-term financial forecasts may not be meaningful in (a) industries with a lengthy operating cycle or (b) situations where long-term results are necessary to evaluate the investment consequences involved. It may not be practical in all situations to present financial forecasts for enough future periods to demonstrate the long-term results. In those circumstances, the presentation should include a description of the potential effects of such results.

For example, if a real estate entity's forecast does not extend to the period in which the entity's investment is expected to be liquidated, the disclosures would include a discussion of the effects of a liquidation at the end of the forecast period. Exhibit 3 in section 410 illustrates such a disclosure.

Distinguishing From Historical Financial Statements

.34 Financial forecasts should be clearly labeled to preclude a reader from confusing them with historical financial statements.

.35 Prior-period information, such as historical results, and financial forecasts for prior periods may be presented alongside financial forecasts to facilitate comparison. When such prior-period information is presented, it should be clearly labeled and distinguished from the financial forecasts.

Correction and Updating of a Financial Forecast

.36 Correction of a financial forecast refers to modification of the forecast after issuance for an error that was made in preparing the forecast. Updating a financial forecast refers to changing the forecast to reflect changes in assumptions, actual results, or anticipated events and circumstances.

.37 *Correction.* Where the responsible party discovers that an error was made in preparing a financial forecast, it should determine if any users are currently relying or are likely to rely on the forecast and, if so, consider whether it is necessary to withdraw the forecast. If the responsible party concludes that it is necessary to withdraw the forecast, it should make a reasonable effort to inform any such users that the forecast is no longer to be relied upon and, where practical, issue a corrected forecast. For examples of how such notification might be made, see SAS No. 1, section 561.06.

.38 *Updating.* It is not usually expected that forecasts will be updated and the responsible party may wish to consider stating in the presentation that it does not intend to update the forecast.[13] Nevertheless, there may be situations where updating would be

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13. However, see Regulation S–K section 229.10(b)(3)(iii) (reprinted in Appendix A), in which registrants are reminded of their responsibility to update forecasts under SEC regulations.

appropriate, for example, when a material event occurs while an entity's debt or equity interests are currently being offered for sale. In deciding whether it would be appropriate to issue an updated financial forecast, the responsible party should consider whether users would expect prospective statements to be updated. Updating requires reanalysis of key factors and assumptions and preparation of a new financial forecast. The reasons for updating should be described in a note to the updated presentation.

.39 The following is an example of an explicit statement regarding a financial forecast not intended to be updated to be included in the summary of significant assumptions.

> This financial forecast was prepared as of March 30, 19XX, to assist the prospective bondholders in estimating whether the operations of the XYZ Company may be expected to support a $10,000,000 bond issue. Because it is contemplated that the entire bond issue will be sold within ninety days hereafter, management does not intend to revise this forecast to reflect changes in present circumstances or the occurrence of unanticipated events.

.40 When the responsible party has decided that an updated forecast is appropriate but cannot be issued promptly, appropriate disclosure should be made to persons who are currently relying or who are likely to rely on the forecast. Such disclosure would include a description of the circumstances necessitating an updated financial forecast and notification that the current forecast should not be used for any purpose and that an updated financial forecast will be issued upon its completion.

.41 If, however, the responsible party decides that the current financial forecast should no longer be used for any purpose but it is not appropriate to issue an updated forecast, this decision and the reason for it should be disclosed to persons who are currently relying or who are likely to rely on the forecast.

Section 410

Illustrative Prospective Financial Statements

.01 This section illustrates prospective financial statements presented in conformity with the presentation guidelines in section 400. The examples presented in this section were designed to illustrate forecasts and projections presented as full and minimum presentations, the use of different bases of accounting, and the use of a range. The unique features of each presentation are described below:

a. Exhibits 1 and 2 in this section are financial forecasts for a manufacturing or commercial type of entity. Although the preferable presentation of prospective financial statements ordinarily consists of a complete set of statements (similar to the entity's historical financial statements) as shown in example 1, a presentation may be limited to the applicable minimum items described in section 400.06 as shown in exhibit 2.

b. Exhibit 3 illustrates a financial forecast presented on a tax basis of accounting typically used for limited partnership ventures. Such ventures do not normally prepare financial statements on other than a tax basis; accordingly, the minimum presentation items in section 400.06 were adapted to fit a tax-basis presentation.

c. Exhibit 4 illustrates a financial forecast expressed in the form of a range representing two scenarios: one, a continued downturn in the economy, and the other, the beginning of recovery in the economy.

d. Exhibit 5 illustrates a financial projection. The example shown is a cash-flow projection that assumes the construction of an additional plant. Because of the hypothetical assumption (the construction of the plant), the presentation can be expected to be useful only to the responsible party and the party with whom the entity is dealing directly in regard to the construction or financing of the plant.

.02 Section 400.06 indicates that the minimum disclosure items need be presented only when applicable but should be adapted as necessary to portray operations. Exhibit 3 illustrates how the minimum items might be adapted in the case of an entity in the business of renting property. The example meets the minimum presentation guidelines as follows:

Minimum Disclosure Item	Exhibit 3 Presentation
a. Sales or gross revenue	Rental income
b. Gross profit or cost of sales	Not applicable
c. Unusual or infrequently occurring items	Not applicable
d. Provision for income taxes	Not applicable
e. Discontinued operations or extraordinary items	Not applicable
f. Income from continuing operations	Same as g; not separately presented
g. Net income	Taxable income (loss)
h. Primary and fully diluted earnings per share	Share of taxable income (loss) per unit
i. Significant changes in financial position	• Investment by limited partners • Financing • Construction expenditures • Repayments of principal • Cash distributions
j. A description of what the responsible party intends the financial forecast to present, a statement that the assumptions are based upon the responsible party's judgment at the time the prospective information was prepared, and a caveat that the forecasted results may not be attained.	Introduction to the forecast
k. Summary of significant assumptions	Summary of significant forecast assumptions
l. Summary of significant accounting policies	(Not illustrated)

.03 Exhibit 3 includes disclosure of the potential tax consequences if the property were to be sold at the end of the forecast period as an aid to users in evaluating long-term investment consequences, since the forecast does not extend to the period in which the property is expected to be sold.

.04 The example of a financial projection (exhibit 5) illustrates a reconciliation from net income using the accrual method of accounting, which is to be used to prepare the historical financial statements for the prospective period, to net increase (decrease) in cash (as specified in section 400.15).

.05 The illustrations presented are consistent with the guidance in section 400, although other presentation formats could also be consistent. For instance, although all of the examples present the summary of significant assumptions and accounting policies after the presentation of prospective amounts, it would also be appropriate to present them first. Further, it may be appropriate to commingle the disclosures of assumptions and accounting policies rather than present them separately. It may also be appropriate to present them in a less formal manner than illustrated, such as computer printed output (indicating data and relationships) from "electronic spreadsheet" and general purpose financial modeling software, as long as the responsible party believes that the disclosures and assumptions can be understood by the users. The appropriateness of any format depends upon individual circumstances.

EXHIBIT 1

XYZ COMPANY, INC.
Forecasted Statement of Income and Retained Earnings
Year Ending December 31, 19X3
(in thousands except per-share amounts)

	Forecasted	*Comparative Historical Information*	
	19X3	*19X2*	*19X1*
Net sales	$101,200	$91,449	$79,871
Cost of sales	77,500	70,140	60,463
Gross profit	23,700	21,309	19,408
Selling, general, and administrative expenses	15,100	13,143	11,014
Operating income	8,600	8,166	8,394
Other income (deductions):			
Miscellaneous	1,700	964	(308)
Interest expense	(2,400)	(1,914)	(1,943)
	(700)	(950)	(2,251)
Income before income taxes	7,900	7,216	6,143
Income taxes	3,400	3,267	2,929
Net income	4,500	3,949	3,214
Retained earnings at beginning of year	10,500	7,803	5,543
Dividend (per share 19X3: $1.50; 19X2: $1.35; 19X1: $1.00)	(1,400)	(1,288)	(954)
Retained earnings at end of year	$ 13,600	$10,464	$ 7,803
Earnings per share	$ 4.73	$ 4.14	$ 3.37

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

EXHIBIT 1 (cont.)

XYZ COMPANY, INC.
Forecasted Statement of Changes in Financial Position
Year Ending December 31, 19X3
(in thousands)

	Forecasted	*Comparative Historical Information*	
	19X3	*19X2*	*19X1*
Sources of Cash:			
Net income	$ 4,500	$3,949	$3,214
Depreciation, which does not use cash	2,800	2,422	2,181
Working capital provided by operations	7,300	6,371	5,395
Changes in certain working capital items not affecting cash:			
Accounts receivable	(2,500)	(1,430)	(483)
Inventory	(100)	(3,995)	(1,431)
Other current assets	(1,700)	(350)	(62)
Accounts payable and accrued expenses	1,100	1,696	846
Other current liabilities		811	161
Cash provided by operations	4,100	3,103	4,426
Increase (decrease) in:			
Notes payable to bank	1,500	100	(300)
Current installments of long-term debt	400	958	342
Proceeds from long-term borrowing	6,000	4,100	2,000
	12,000	8,261	6,468

Uses of Cash:			
Dividend	1,400	1,288	954
Current installments and repayment of long-term debt	2,600	3,800	2,300
Additions to plant and equipment	4,400	2,907	2,114
Increase in other assets	2,200	600	83
	10,600	8,595	5,451
Increase (decrease) in cash	1,400	(334)	1,017
Cash beginning of year	1,900	2,196	1,179
Cash end of year	$ 3,300	$1,862	$2,196

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

EXHIBIT 1 (cont.)

XYZ COMPANY, INC.
Forecasted Balance Sheet
December 31, 19X3
(in thousands)

	Forecasted	*Comparative Historical Information*	
	19X3	*19X2*	*19X1*
ASSETS			
Current assets:			
Cash	$ 3,300	$ 1,862	$ 2,196
Accounts receivable (net)	14,900	12,438	11,008
Inventory	27,000	26,932	22,937
Other	3,500	1,813	1,463
Total current assets	48,700	43,045	37,604
Property, plant, and equipment	30,900	26,915	22,832
Less accumulated depreciation	17,300	14,912	11,314
Net property, plant, and equipment	13,600	12,003	11,518
Other assets	5,000	2,714	2,114
	$67,300	$57,762	$51,236

LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities:			
Notes payable to bank	$ 4,600	$ 3,100	$ 3,000
Accounts payable and accrued expenses	12,300	11,193	9,497
Current installments of long-term debt	4,400	3,968	3,010
Other	900	925	114
Total current liabilities	22,200	19,186	15,621
Long-term debt, excluding current installments	20,100	16,700	16,400
Stockholders' equity:			
Capital stock	11,400	11,412	11,412
Retained earnings	13,600	10,464	7,803
Total stockholders' equity	25,000	21,876	19,215
	$67,300	$57,762	$51,236

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

Exhibit 1 presents one format for prospective financial statements. However, a more summarized presentation may be given (see section 400.06). Following is a summarized presentation that could be used in lieu of the preceding exhibit.

EXHIBIT 2

XYZ COMPANY, INC.
Summarized Financial Forecast
Year Ending December 31, 19X3
(in thousands except per-share amounts)

	Forecasted	*Comparative Historical Information**	
	19X3	*19X2*	*19X1*
Sales	$101,200	$ 91,449	$ 79,871
Gross profit	23,700	21,309	19,408
Income tax expense	3,400	3,267	2,929
Net income	4,500	3,949	3,214
Earnings per share	4.73	4.14	3.37
Significant anticipated changes in financial position:			
Cash provided by operations	4,100	3,103	4,426
Net increase (decrease) in long-term borrowings	3,400	300	(300)
Dividend (per share 19X3: $1.50; 19X2: $1.35; 19X1: $1.00)	1,400	1,288	954
Additions to plant and equipment	4,400	2,907	2,114
Increase (decrease) in cash	1,400	(334)	1,017

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

*Comparative historical information is not part of the minimum presentation described in section 400.06.

EXHIBITS 1 AND 2 (cont.)

XYZ COMPANY, INC.
Summary of Significant Forecast Assumptions and Accounting Policies
Year Ending December 31, 19X3

This financial forecast presents, to the best of management's knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the forecast period.[1] Accordingly, the forecast reflects its judgment as of February 17, 19X3, the date of this forecast, of the expected conditions and its expected course of action. The assumptions disclosed herein are those that management believes are significant to the forecast. There will usually be differences between forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. The comparative historical information for 19X1 and 19X2 is extracted from the Company's financial statements for those years. Those financial statements should be read for additional information.

a. **Summary of Significant Accounting Policies.** (not illustrated)

b. **Sales.** The overall market for the Company's products has grown over the past five years at an average rate of 2 percent above the actual increase in gross national product, and the Company's market share has remained steady at 14 to 16 percent. Based on a recent market study of demand for the Company's products, sales are forecasted to increase 11 percent from 19X2 (which is 2 percent above the Department of Commerce Bureau of Economic Analysis estimate of the rise in gross national product in the forecast period), with a market share of 15 percent and unit price increased to cover a significant portion of forecasted increases in cost of manufacturing.

c. **Cost of Sales**

Materials. Materials used by the Company are expected to be readily available, and the Company has generally used producer associations' estimates of prices in the forecast period to forecast material costs. The price for copper, a major raw material in the Company's products, recently has been disrupted by political

1. For the presentation illustrated in exhibit 2, this would read ". . . summary of the Company's expected results of operations and changes in financial position. . . ."

events in certain principal producer countries. As a result, industry estimates of copper prices in the forecast period range from 15 to 30 percent above 19X2 prices. The Company expects to be able to assure sufficient supplies and estimates that the cost of copper will increase by 22 percent over 19X2. However, due to the uncertainties noted above, the realization of the forecast is particularly sensitive to the actual price increase. A variation of five percentage points in the actual increase above or below the assumed increase would affect forecasted net earnings by approximately $485,000.

Labor. The Company's labor union contract, which covers substantially all manufacturing personnel, was negotiated in 19X2 for a three-year period. Labor costs are forecasted based upon the terms of that contract.

d. **Plant and Equipment and Depreciation Expense.** Forecasted additions to plant and equipment, $4.4 million, comprise principally the regular periodic replacement of manufacturing plant and vehicles at suppliers' quoted estimated prices and do not involve a significant change in manufacturing capacity or processes. Depreciation is forecasted on an item-by-item basis.

e. **Selling, General, and Administrative Expenses.** The principal types of expense within this category are salaries, transportation costs, and sales promotion. Salaries are forecasted on an individual-by-individual basis, using expected salary rates in the forecast period. Transportation costs comprise principally the use of contract carriers; volume is forecasted based upon the sales and inventory forecasts (including forecasts by sales outlet), and rates are forecasted to rise by 16 percent over 19X2, based upon trucking industry forecasts. Sales promotion costs are expected to increase by approximately 14 percent above the level of 19X2 in order to meet increased competition and maintain market share. The level of other expenses is expected to remain the same as in 19X2, adjusted for expected increases in line with the consumer price index (assumed to rise 9 percent on the mean of [*several widely used estimates*]).

f. **Miscellaneous Income.** The forecast assumes royalty income of $950,000 will be received based on an agreement under which the Company is to receive a minimum of $950,000 for the first 10,000,000 units produced under its patented die casting process and $.05/unit above that level. Management believes it is unlikely that production will exceed 10,000,000 units. The balance of miscellaneous income is assumed to come from investment of excess cash and other sources.

g. **Bank Borrowings and Interest Expenses.** The forecast assumes that the Company will obtain an extension of existing short-term lines of credit at terms comparable to those in effect in 19X2 (2 percent over prime rate). The Company used the arithmetic mean of [*three widely used estimates*] of bank prime rate during the forecast period (ranging from 12 percent to 14 percent) to estimate prime rate at 13 percent. However, because of recent volatility in the financial markets, short-term interest rates have been very unstable, ranging from 12 percent to 17 percent during 19X2.

   The Company has forecasted additional long-term borrowings of $6 million and has entered into preliminary negotiations with its bankers for this financing. The borrowings are principally to fund purchases of plant and equipment and additions to other long-term assets and will be secured by such additions. Based upon the preliminary negotiations, the Company has assumed that the additional long-term financing will bear interest at 14 percent.

h. **Income Taxes.** The provision for income taxes is computed using the statutory rates in effect during 19X2, which are not expected to change, and assuming investment tax credit on qualifying investments at rates in effect in 19X2.

i. **Dividend.** The Company's normal dividend policy is to pay out the previous year's dividend increased to the extent of at least one-third of any increase in profits over the previous year, provided the board of directors considers that the Company's cash and working capital position will not be adversely affected. The dividend has been forecasted at $1.50 per share, assuming an increased payout over 19X2 of one-third of the excess of forecasted net earnings for the year ending December 31, 19X3, above those of 19X2.

EXHIBIT 3

DEF ASSOCIATES, LTD.
(A Limited Partnership)
Statement of Forecasted Taxable Income (Loss)
Eight Years Ending December 31, 19X8

	Reference	*19X1*	*19X2*	*19X3*	*19X4*	*19X5*	*19X6*	*19X7*	*19X8*
Rental income	d	$ —	$ 105,000	$ 378,000	$ 438,165	$ 468,837	$ 501,655	$536,771	$574,345
Expenses									
Preoccupancy rental and advertising expenses	e	7,000	33,800	—	—	—	—	—	—
Operating expenses	f	—	46,216	133,596	144,426	149,947	155,854	162,175	168,938
Mortgage interest	h	—	83,950	172,003	185,500	183,000	180,000	176,800	173,310
Amortization of construction period interest and taxes	e	1,765	22,865	22,865	22,865	22,865	22,865	22,865	22,865
Depreciation	g	—	41,898	100,556	100,556	100,556	100,556	100,556	100,556
Total expenses		8,765	228,729	429,020	453,347	456,368	459,275	462,396	465,669
Taxable income (loss) for year		(8,765)	(123,729)	(51,020)	(15,182)	12,469	42,380	74,375	108,676
Percentage of interest of limited partners	c	95%	95%	95%	95%	95%	95%	95%	95%
Limited partners' share of taxable income (loss)		$ (8,327)	$ (117,543)	$ (48,469)	$ (14,423)	$ 11,846	$ 40,261	$ 70,656	$103,242
Cumulative		$ (8,327)	$ (125,870)	$ (174,339)	$ (188,762)	$ (176,916)	$ (136,655)	$ (65,999)	$ 37,243

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

EXHIBIT 3 (cont.)

DEF ASSOCIATES, LTD.
(A Limited Partnership)
Statement of Forecasted Sources and Uses of Cash
Eight Years Ending December 31, 19X8

	Reference	*19X1*	*19X2*	*19X3*	*19X4*	*19X5*	*19X6*	*19X7*	*19X8*
Sources of cash									
Investment of general partner		$ 20,000	$ 30,000	$ —	$ —	$ —	$ —	$ —	$ —
Investment by limited partners	b	500,000	—	—	—	—	—	—	—
Outside financing	h	129,000	1,421,000	—	—	—	—	—	—
		649,000	1,451,000	—	—	—	—	—	—
Cash from operations									
Taxable income (loss)		(8,765)	(123,729)	(51,020)	(15,182)	12,469	42,380	74,375	108,676
Add:									
Amortization of construction period interest and taxes	e	1,765	22,865	22,865	22,865	22,865	22,865	22,865	22,865
Depreciation	g	—	41,898	100,556	100,556	100,556	100,556	100,556	100,556
Cash from operations		(7,000)	(58,966)	72,401	108,239	135,890	165,801	197,796	232,097
Total sources		642,000	1,392,034	72,401	108,239	135,890	165,801	197,796	232,097
Uses of cash									
Syndication costs		21,500	—	—	—	—	—	—	—
Construction costs		587,850	1,192,150	30,000	—	—	—	—	—
Construction period interest and taxes	e	17,650	211,000	—	—	—	—	—	—
Repayment of mortgage principal	h	—	—	14,862	18,355	20,888	23,771	27,055	30,588
Distributions to limited partners	c								
Initial return		—	—	24,474	89,884	115,002	142,030	128,610	—
After initial return		—	—	—	—	—	—	27,386	130,981
Distributions to general partner	c	—	—	—	—	—	—	14,745	70,528
Total uses		627,000	1,403,150	69,336	108,239	135,890	165,801	197,796	232,097
Change in cash		15,000	(11,116)	3,065	—	—	—	—	—
Cash balance, beginning of year		—	15,000	3,884	6,949	6,949	6,949	6,949	6,949
Cash balance, end of year		$ 15,000	$ 3,884	$ 6,949	$ 6,949	$ 6,949	$ 6,949	$ 6,949	$ 6,949

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

DEF ASSOCIATES, LTD.
(A Limited Partnership)
Forecasted Statement of Allocation of Limited Partner Interest Per $5,000 Unit and Presentation of Tax Effects Assuming a 50% Tax Bracket
Eight Years Ending December 31, 19X8

	Reference	*19X1*	*19X2*	*19X3*	*19X4*	*19X5*	*19X6*	*19X7*	*19X8*
Limited partner investment per unit	b	$ 5,000	$ —	$ —	$ —	$ —	$ —	$ —	$ —
Share of taxable income (loss)	c	$ (83)	$ (1,175)	$ (485)	$ (144)	$ 118	$ 403	$ 707	$1,032
Assumed tax bracket	i	50%	50%	50%	50%	50%	50%	50%	50%
Tax benefit (cost)		42	588	242	72	(59)	(201)	(353)	(516)
Cash distributions	c	—	—	245	899	1,150	1,420	1,560	1,310
Total tax benefits and cash distributions		$ 42	$ 588	$ 487	$ 971	$ 1,091	$ 1,219	$1,207	$ 794
Cumulative cash flow		$ (4,958)	$ (4,370)	$ (3,883)	$(2,912)	$ (1,821)	$ (602)	$ 605	$1,399
Cumulative taxable income (loss)		$ (83)	$ (1,258)	$ (1,743)	$ (1,887)	$ (1,769)	$ (1,366)	$ (659)	$ 373

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

EXHIBIT 3 (cont.)

DEF ASSOCIATES, LTD.
SUMMARY OF SIGNIFICANT FORECAST ASSUMPTIONS AND ACCOUNTING POLICIES
Eight Years Ending December 31, 19X8

This financial forecast presents, to the best of management's knowledge and belief, the Partnership's expected results of operations and sources and uses of cash for the forecast period presented on the tax basis of accounting. Accordingly, the forecast reflects its judgment as of June 30, 19X1, the date of this forecast, of the expected conditions and its expected course of action. The assumptions disclosed herein are those that management believes are significant to the forecast. There will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected and those differences may be material.

The body of tax law is in a continuous state of change. Accordingly, there could be developments, statutory or otherwise, that would alter the forecast. Because transactions are susceptible to varying interpretations under income tax law, rulings, and regulations, the Internal Revenue Service may not concur with the determinations of the factual issues and the interpretations of existing law, rulings, and regulations that served as the basis for the assumptions used by management to prepare the forecast. Such differences might alter the forecast. (See other comments on this subject on pages aa-bb of this offering memorandum.)

a. **Summary of Significant Accounting Policies.** (not illustrated)

b. **Description of the Project.** The proposed development, DEF Gardens, is a seventy-unit apartment complex to be constructed on an eight-and-one-quarter acre residentially zoned parcel of land in Phoenix, Arizona, to be leased from the General Partner (see note **f**). Construction of the development is anticipated to begin on July 15, 19X1, and be completed by August 1, 19X2, (see note **e**). Equity financing is proposed to be obtained from the sale of 100 limited partnership units at $5,000 per unit in July 19X1. The proceeds from the sale, together with anticipated bank financing, are expected to provide the necessary funding requirements for the project (see note **h**).

c. **Allocation of Income, Losses, and Cash Distributions**. The Partnership Agreement provides that the limited partners (as a group) are to (1) share in 95 percent of the Partnership's net income or loss, and (2) receive 100 percent of all cash distributions from operations until such time as the limited partners have received back their original investments. Thereafter, all distributions are to be allocated 65 percent to the limited partners (as a group) and 35 percent to the General Partner, including distributions, if any, on the refinancing, sale, or disposition of the partnership properties. Cash available for distributions will be reserved to the extent necessary to provide for normal operating needs. The initial cash distribution is forecasted to occur in 19X3 and annually thereafter.

Income or losses of the Partnership for a year are allocable to the partners pro rata to the portions of the year in which the respective partners were members of the Partnership. The forecast of the allocation of the net loss to be sustained for the year 19X2 is based on the assumption that all limited partners will acquire their interest in the partnership as of July 1, 19X1.

d. **Rental Income**. Rental income is based upon the General Partner's estimates that the apartment building will be available for occupancy on or before August 1, 19X2, and the number of units occupied, average rent per unit, and percentage occupancy will be as follows.

	8/1/X2 to 12/31/X2	19X3	19X4	19X5	19X6	19X7	19X8
Average number of units occupied	40	60	65	65	65	65	65
Average monthly rental per unit	$525	$525	$562	$601	$643	$688	$736
Average percentage	57%	86%	93%	93%	93%	93%	93%

The average monthly rental per unit is forecasted to increase 7 percent per year from 19X4 through 19X8 based upon the most recent experience in the area. Occupancy percentage is based upon the General Partner's consideration of demand for the forecast period and is consistent with percentages currently obtained in similar apartment complexes managed by the General Partner. For each 30-day period subsequent to August 2, 19X2, that occupancy is delayed, if any, rental income for 19X2 will be reduced by approximately $21,000.

e. **Construction Period Expenses**. Expenses expected to be incurred during the construction period (July 15, 19X1, to August 1, 19X2) consist of the following:

	19X1	19X2
Interest on construction loan	$16,900	$203,000
Real estate taxes	750	8,000
Amortizable over 10 years	$17,650	$211,000
Rental and advertising expenses	$ 7,000	$ 33,800

Such expenses are based upon the General Partner's most recent experience in similar apartment complexes in the area. Interest on the construction loan and real estate taxes incurred during the construction period will be amortized on a straight-line basis over ten years, in accordance with IRS regulations. For each thirty-day period subsequent to August 2, 19X2, that construction continues, construction period expenses for 19X2 (primarily interest) will increase by approximately $25,000.

f. **Operating Expenses**. Annual expenses for the operating of the Partnership's property are based on the General Partner's experience in similar apartment complexes. Operating expenses include salaries for the apartment manager, repairs and maintenance, cleaning, insurance, real estate taxes, and utilities. They also include a management fee of $10,000 per year to the General Partner and lease payments to the General Partner of $4,630 per month for the use of the land on which the apartment complex is to be constructed. The initial fixed term of the lease is for twenty-five years with an option to renew for an additional twenty-five years.

g. **Construction Costs and Depreciation**. The forecasted construction costs are based on a fixed-price contract with the general contractor. The total estimated cost of constructing the project is $1,810,000, excluding capitalized construction period interest and taxes. Depreciation is computed using the straight-line method based on an Accelerated Cost Recovery System (ACRS) useful life of eighteen years.

h. **Financing Arrangements**. Construction of the seventy-unit apartment project and construction period expenses are to be financed by a $1,550,000 construction loan and capital contributions of $500,000 by the limited partners and $50,000 by the

General Partner. It is anticipated that the loan will bear interest at an annual interest rate of 14 percent. Upon completion of construction, a permanent thirty-year nonrecourse mortgage loan will become effective at an anticipated annual interest rate of 13 percent, payable interest only for one year and principal amortization and interest payments thereafter. For each .25 percent variance in the actual interest rates obtained, the dollar amount of interest expense, and the resulting taxable income or loss will vary by approximately $2,000 in 19X2 and $4,000 in 19X3 through 19X8.

i. **Tax Matters**. The Partnership is relying on an opinion from its legal counsel (included on pages xx-yy of this offering memorandum) that it is more likely than not that the investors will prevail on the merits of each material tax issue and that the material tax benefits in the aggregate are likely to be realized.

   State and local income taxes are not provided for in this forecast. Each partner may be liable for state and local income taxes on his portion of the Partnership's profits and should consult his personal tax advisor in this regard.

j. **Analysis of the Tax Effect and Cash Flow on the Sale of the Property at the End of the Forecast Period**. The following table illustrates the effect on limited partners of a hypothetical sale of the apartment complex at December 31, 19X8, given two different hypothetical sales prices, and the subsequent liquidation of the partnership. This table is presented for analysis purposes only because it is not expected that the property will be sold at that date or for those hypothetical amounts. These illustrations are based on the following:

   1. Column A is based on the hypothetical assumption that the property will be sold (or foreclosed) for the balance of the mortgage at December 31, 19X8.
   2. Column B is based on the hypothetical assumption that the property will be sold for $500,000 net cash (the limited partners' original capital contributions) subject to the existing mortgage.
   3. These illustrations do not reflect the effect of (a) capital losses from other transactions or (b) the alternative minimum tax in the year of sale, if any, since these factors would be dependent upon each individual partner's tax situation.

DEF ASSOCIATES, LTD.
Effect on Limited Partners of Hypothetical Sale of Property
December 31, 19X8

	A *Sale for Existing Mortgage Balance*	B *Sale for Existing Mortgage Balance and Original Capital Contribution*
Gross sales price	$ 1,414,481	$ 1,914,481
Less mortgage balance	(1,414,481)	(1,414,481)
Proceeds available for distribution	—	500,000
Limited partners' share of proceeds	65%	65%
Total distribution	$ —	$ 325,000
Distribution per $5,000 unit	$ —	$ 3,250
Limited partners' share of long-term capital gain on sale and dissolution:		
Cumulative taxable gains	$ (37,246)	$ (37,246)
Write-off of unamortized construction period interest and taxes	63,489	63,489
Cash distributions:		
Annual amounts	658,366	658,366
Remaining working capital	4,517	4,517
From sale	—	325,000
	689,126	1,014,126

Less original capital contribution	500,000	500,000
Gain from sale and liquidation	$ 189,126	$ 514,126
Long-term capital gain per $5,000 unit	$ 1,891	$ 5,141
Tax on long-term capital gain (per unit) assuming 50% tax bracket (20%)	$ 378	$ 1,028
Net after tax cash flow (deficiency) per unit from sale and dissolution	$ (378)	$ 2,222
Net after tax operating cash flow per unit	6,399	6,399
Remaining working capital distribution per unit	45	45
Tax savings from write-off of unamortized construction period interest and taxes per unit	317	317
After tax return on $5,000 investment per unit	$ 6,383	$ 8,983

EXHIBIT 4

JMK COMPANY, INC.

Consolidated Statements of Income and Retained Earnings
For Years Ending December 31, 19X8 (forecasted)
and December 31, 19X7 and 19X6 (historical)
(in thousands except per-share amounts)

	Forecasted 19X8		*Comparative Historical Information*	
	Economy Begins Recovery	*Continued Downturn in the Economy*	*19X7*	*19X6*
Net sales	$639,000	$599,000	$619,008	$628,273
Costs and expenses:				
Costs of sales	510,000	488,500	490,091	487,607
Selling and advertising	31,420	32,060	31,324	28,775
General and administrative	33,600	33,500	31,255	27,752
Interest	1,700	1,650	2,818	2,839
Other (net)	1,030	1,030	(161)	352
Total	577,750	556,740	555,327	547,325
Income before income taxes	61,250	42,260	63,681	80,948
Income taxes	27,125	18,390	28,287	39,256
Net income	34,125	23,870	35,394	41,692

Retained earnings beginning of year	237,698	237,698	215,966	186,374
Cash dividends	16,758	15,613	13,662	12,100
Retained earnings end of year	$255,065	$245,955	$237,698	$215,966
Net income per common share	$ 3.50	$ 2.45	$ 3.63	$ 4.27

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

EXHIBIT 4 (cont.)

JMK COMPANY, INC.
Consolidated Statements of Changes in Financial Position
For Years Ending December 31, 19X8 (forecasted)
and December 31, 19X7 and 19X6 (historical)
(in thousands)

	Forecasted 19X8		*Comparative Historical Information*	
	Economy Begins Recovery	*Continued Downturn in the Economy*	*19X7*	*19X6*
Source of cash:				
Net income	$34,125	$23,870	$35,394	$41,692
Depreciation	19,500	19,360	17,986	16,342
Amortization	2,170	2,170	225	227
Deferred compensation	2,080	1,980	1,637	274
Receivables	(3,000)	2,950	(7,586)	(11,794)
Inventories	(2,200)	11,260	8,059	(19,533)
Prepaid expenses	(550)	(550)	1,633	(3,831)
Accounts payable	2,000	1,620	1,682	2,730
Accrued liabilities	(3,600)	(3,465)	(1,611)	(4,328)
Income taxes	50	480	(3,979)	4,503
Other items	1,400	1,280	(17,980)	12,015
Total cash from operations	51,975	60,955	35,460	38,297
Disposition of property	528	528	783	758
Decrease in other assets	2,700	2,682	—	3,320
Bond financing	—	—	15,500	—
Increase in long-term debt	3,588	—	—	—
	58,791	64,165	51,743	42,375

Application of cash:				
Dividends	16,758	15,613	13,662	12,100
Property, plant, and equipment	30,500	29,300	32,404	25,671
Reduction in long-term debt	—	1,518	245	14,225
Increase in long-term receivables	1,533	1,533	250	3,111
Increase in other assets	—	—	5,672	—
	48,791	47,964	52,233	55,107
Increase (decrease) in cash	$10,000	$16,201	$ (490)	$(12,732)

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

EXHIBIT 4 (cont.)

JMK COMPANY, INC.
Summary of Significant Forecast Assumptions and Accounting Policies
For the Year Ending December 31, 19X8

This financial forecast presents, to the best of management's knowledge and belief, the Company's expected consolidated statements of income and retained earnings and changes in financial position for the forecast period assuming either a recovery in the economy or a continued downturn in the economy. Accordingly, the forecast reflects its judgment as of January 31, 19X8, the date of this forecast, of the expected conditions and its expected course of action under each scenario. The assumptions disclosed herein are those that management believes are significant to the forecast. Management reasonably expects, to the best of its knowledge and belief, that the level of economic activity will be within the range shown; however, there can be no assurance that it will. Further, even if the level of economic activity is within the range shown, there will usually be differences between forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material, and the actual results may be outside the ranges presented.

a. **Summary of Significant Accounting Policies.** (not illustrated)

b. **Sales.** The sales of the Company have been closely related to the level of activity in the economy. Economists are currently divided in their forecasts of overall economic activity for 19X8. Consequently, management has prepared its forecast in the form of alternative scenarios: one, representing a continued downturn in the economy based on a 2 percent decrease in real GNP for the forecast period, and the other, a beginning of economic recovery based on a 2 percent increase in real GNP for the period. It is anticipated that much of the differences between the two scenarios would be concentrated in the automotive sector of the Company's business.

c. **Cost of Sales.** The forecast assumes that management is able to maintain tight controls over manufacturing costs and inventory levels. If the downturn in the economy continues, management plans to continue substantial reduction in inventory levels. However, if the economy recovers, the Company will begin rebuilding the level of inventories.

d. **Selling and Advertising.** The forecast assumes that cost control measures will allow the Company to maintain selling costs at a relatively constant level. The Company plans to spend more on promotional campaigns if the economic downturn persists.

e. **General and Administrative Expense.** The forecast anticipates a \$1.7 million increase in the level of general and administrative expense due primarily to the development of new computer-based information systems to better control the Company's performance.

f. **Income Taxes.** The provision for income taxes is computed using the rates currently in effect for 19X8.

g. **Long-Term Debt.** The Company anticipates a modest reduction in long-term debt if the decline in the economy persists. However, if the economy turns around, the Company expects to increase long-term debt at an interest rate of 1 point above prime.

h. **Dividend.** The Company's policy is to pay out a predetermined portion of net income, and the forecasted dividend assumes continuation of that policy.

EXHIBIT 5

ABC COMPANY, INC.
Statement of Projected Results of Operations and Cash Flow Assuming Construction of an Additional Plant
For the Five Years Ending December 31, 19X7
(in thousands except per-share amounts)

	Year Ending December 31				
	19X3	*19X4*	*19X5*	*19X6*	*19X7*
Net sales	$101,200	$112,300	$142,000	$156,200	$173,400
Cost of sales	77,500	86,100	109,300	120,100	133,300
Gross profit	23,700	26,200	32,700	36,100	40,100
Selling, general, and administrative expenses	15,100	16,500	19,500	21,400	23,400
Operating income	8,600	9,700	13,200	14,700	16,700
Other income (deductions):					
Miscellaneous	1,700	1,200	1,000	1,300	1,800
Interest expense	(2,400)	(3,500)	(3,400)	(3,200)	(3,000)
	(700)	(2,300)	(2,400)	(1,900)	(1,200)
Income before taxes	7,900	7,400	10,800	12,800	15,500
Income taxes	3,400	2,800	4,700	5,500	6,700
Net income	4,500	4,600	6,100	7,300	8,800
Add noncash expenses:					
Depreciation and amortization	2,800	2,800	3,400	3,500	3,500
Deferred taxes	500	450	550	600	650
	7,800	7,850	10,050	11,400	12,950

Add (deduct):					
Loan proceeds for additional plant facility	8,500	1,500	—	—	—
Increase in excess of receivables and other assets over payables	(1,000)	(1,000)	(2,000)	(3,000)	(3,500)
Cash requirements for building costs	(8,200)	(1,800)	—	—	—
Other additions to plant and equipment	(3,400)	(2,200)	(2,200)	(2,200)	(2,200)
Cash requirements for repayment of debt	(2,600)	(2,600)	(3,700)	(3,500)	(3,500)
Dividends	(1,400)	(1,400)	(1,900)	(2,200)	(2,700)
Increase (decrease) in cash	(300)	350	250	500	1,050
Cash beginning of year	3,300	3,000	3,350	3,600	4,100
Cash end of year	$ 3,000	$3,350	$ 3,600	$ 4,100	$ 5,150
Earnings per share	$ 4.80	$ 4.92	$ 6.51	$ 7.79	$ 9.39
Dividends per share	$ 1.50	$ 1.50	$ 2.03	$ 2.35	$ 2.88

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

EXHIBIT 5 (cont.)

ABC COMPANY, INC.

Summary of Significant Assumptions Employed in Preparation of the Statement of Projected Results of Operations and Cash Flow Assuming Construction of an Additional Plant For the Five Years Ending December 31, 19X7

This financial projection of operations and cash flow assuming construction of an additional plant present, to the best of management's knowledge and belief, the expected results of operations, changes in financial position, and cash flow for the projection period if a plant were constructed to increase production capacity by approximately 20 percent. Accordingly, the projection reflects its judgment as of October 24, 19X2, the date of this projection, of the expected conditions and its expected course of action if such a plant were constructed. The presentation is designed to provide information for potential bank financing of the construction of the additional plant and cannot be considered to be a presentation of expected future results. Accordingly, this projection may not be useful for other purposes. The assumptions disclosed herein are those that management believes are significant to the projection; however, management has not decided that it will construct such a plant. Even if the plant were constructed, there will usually be differences between projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.

a. **Summary of Significant Accounting Policies.** (not illustrated)

b. **Hypothetical Assumption — Increase in Production Capacity by Construction of a New Plant.** The projection is based on the assumption that production capacity will be increased by approximately 20 percent by the construction of a 160,000 square foot production facility in Richmond, Virginia.

   Construction on the new plant is projected to begin in February 19X3 and be completed by June 30, 19X4, at a total cost of $10,000,000 including construction-period interest of $1,300,000. Production cost estimates and the projected completion date have been estimated based on competitive bids received.

   The decision to proceed with the project and awarding of contracts will depend on the completion of financing arrangements.

c. **Sales.** The overall market for the Company's products has grown over the past five years at an average rate of 2 percent above the actual increase in gross national product, and the Company's market share has remained steady at 14 to 16 percent. Based upon a recent market study of demand for the Company's products, sales are projected to increase 11 percent per annum from 19X2 to 19X4 (which is consistent with a rate 2 percent above the Department of Commerce Bureau of Economic Analysis' estimate of the rise in gross national product in the projection period), with a market share of 15 percent and unit prices increased to cover projected increases in cost of manufacturing. Based upon the study, an additional 15 percent increase in sales is projected to occur beginning in 19X5 and will be met by the added capacity resulting from the plant expansion.

d. **Cost of Sales**

Materials. Materials used by the Company are expected to be readily available, and the Company has generally used producer associations' estimates of prices in the projection period to project material costs. The Company expects to be able to assure a sufficient supply of materials and estimates that the cost of materials will increase by 12 percent per annum.

Labor. The Company's labor union contract, which covers substantially all manufacturing personnel, will be subject to renegotiation in 19X6. Labor costs until that time are projected based on the existing contract. For 19X7, labor costs, including fringe benefits, are projected to increase 19 percent per year above the 19X6 level. The outcome of the projection is particularly sensitive to variances in such labor costs. For each percentage point variance from the projected increase, net income and cash will vary by approximately $380,000.

e. **Plant and Equipment and Depreciation Expense.** Projected additions to plant and equipment, other than the assumed plant expansion, are principally the regular periodic replacement of manufacturing plant and vehicles at suppliers' quoted estimated prices and do not involve any significant changes in manufacturing capacity or processes. Depreciation is projected on an item-by-item basis. Depreciation on the new facility is projected on a straight-line basis over twenty years.

f. **Selling, General, and Administrative Expense.** The principal types of expense within this category are salaries, transportation costs, and sales promotion. Salaries are projected on an individual-by-individual basis, using expected salary rates in the projection period. Transportation costs are principally for contract carriers; volume is projected based upon the sales and inventory projections, and rates are forecasted to rise by 16 percent per year based upon trucking industry forecasts. Sales promotion costs are expected to increase in line with the consumer price index, as is the level of other expenses.

g. **Bank Borrowings and Interest Expense.** The projection assumes that the Company will obtain an extension of existing short-term lines of credit at terms comparable to those in effect in 19X2 (2 percent over prime rate). The Company used the arithmetic mean of [*three widely used estimates*] of bank prime rate during the projection period (ranging from 12 percent to 14 percent) to estimate prime rate at 13 percent. The Company projects additional long-term borrowing of $10 million to finance the planned plant expansion (including $1,300,000 of construction-period capitalized interest) and has entered into preliminary negotiations with its bankers for this financing. Based upon the preliminary negotiations, the Company has assumed that the additional long-term financing will bear interest at 14 percent.

h. **Miscellaneous Income.** The projection assumes that royalty income of $950,000 will be received annually based on an agreement under which the Company is to receive a minimum of $950,000 for the first 10,000,000 units produced under its patented die casting process and $.05/unit above that level. Management believes it is unlikely that production will exceed 10,000,000 units in any of the projection periods.

i. **Income Taxes.** The provision for income taxes is computed using the statutory rates in effect during 19X2, which are not expected to change. The Company anticipates that it will take investment tax credits on the machinery and equipment to be installed in the new plant when the plant is placed in service in 19X4.

j. **Dividend.** The Company's normal dividend policy is to pay out the previous year's dividend increased to the extent of at least one-third of any increase in profits over the previous year, provided the board of directors considers that the Company's cash and working-capital position will not be adversely affected.

GUIDANCE FOR ACCOUNTANTS WHO PROVIDE SERVICES ON PROSPECTIVE FINANCIAL STATEMENTS

Section 500

Types of Accountants' Services

Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. *Italicized* paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term "forecast."

.01 The sections that follow provide guidance to accountants concerning performance and reporting for engagements to compile (section 500.04), examine (section 500.06), or apply agreed-upon procedures to (section 500.08) financial forecasts.[1] This guide does not deal comprehensively with accountants' services on presentations that do not meet the minimum presentation guidelines in section 400.06. Such partial presentations are not deemed to be prospective financial "statements" (see section 1000 concerning partial presentations).

.02 Whenever an accountant (a) submits, to his client or others, a financial forecast that he has assembled, or assisted in assembling, that is, or reasonably might be, expected to be used by another (third) party[2] or (b) reports on a financial forecast that is, or reasonably might be, expected to be used by another (third) party,[3] he

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1. The accountant should refer to rule 201(e) of the AICPA Code of Professional Ethics and the related Interpretation 201-2, because this rule and interpretation are applicable to all engagements a member performs involving prospective financial information, including those engagements that are not covered by the provisions of this guide.

2. However, section 500.19 permits an exception to this rule for certain types of budgets.

3. In deciding whether a party that is or reasonably might be expected to use an accountant's report is considered a third party, the accountant should consider the degree of consistency of interest between the responsible party and the user regarding the forecast. If their interests are substantially consistent (for example, both the responsible party and the user are employees of the entity about which the forecast is made), the user would not be deemed a third party. On the other hand, where the interests of the responsible party and the user are potentially inconsist-

(*continued*)

should perform one of the engagements described in the preceding paragraph.[4] In deciding whether the financial forecast is, or reasonably might be, expected to be used by a third party, the accountant may rely upon either the written or oral representation of the responsible party, unless information comes to his attention that contradicts the responsible party's representation. If such third party use of the financial forecast is not reasonably expected, the provisions of this guide are not applicable unless the accountant has been engaged to examine, compile, or apply agreed-upon procedures to the financial forecast (however, see section 900 for advice on internal-use-only services).

.03 This guide does not provide standards or procedures for engagements involving financial forecasts used solely in connection with litigation support services, although it provides helpful guidance for many aspects of such engagements and may be referred to as useful guidance in such engagements. *Litigation support services* are engagements involving pending or potential formal legal proceedings before a "trier of fact" in connection with the resolution of a dispute between two or more parties, for example, in circumstances where an accountant acts as an expert witness. This exception is provided because, among other things, the accountant's work in such proceedings is ordinarily subject to detailed analysis and challenge by each party to the dispute. The guide applies, however, if the financial forecast is for use by third parties who, under the rules of the proceedings, do not have the opportunity for such analysis and challenge. For example, creditors may not have such opportunities when the financial forecast is submitted to them to secure their agreement to a plan of reorganization.

.04 A compilation of a financial forecast is a professional service that involves—

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ent (for example, the responsible party is a nonowner manager and the user is an absentee owner), the user would be deemed a third party. In some cases, this determination will require the exercise of considerable professional judgment.

4. This requirement does not preclude limited distribution of a financial forecast that is clearly identified as a draft prior to the issuance of the accountant's report. When a forecast is issued as a draft it is not deemed to be submitted, since the forecast may be relied upon only when the final forecast and accountant's report are submitted. An accountant should not undertake an engagement to assist in assembling a financial forecast that is, or reasonably might be, expected to be used by another (third) party without intending to issue a final report.

a. Assembling, to the extent necessary, the financial forecast based on the responsible party's assumptions.
b. Performing the required compilation procedures,[5] including reading the financial forecast with its summaries of significant assumptions and accounting policies, and considering whether they appear to be (i) presented in conformity with AICPA presentation guidelines[6] and (ii) not obviously inappropriate.
c. Issuing a compilation report.

.05 A compilation is not intended to provide assurance on a financial forecast or the assumptions underlying it. Because of the limited nature of the accountant's procedures, a compilation does not provide assurance that the accountant will become aware of significant matters that might be disclosed by more extensive procedures, for example, those performed in an examination of a financial forecast. Sections 600 through 620 provide guidance on engagements to compile a financial forecast.

.06 An examination of a financial forecast is a professional service that involves—

a. Evaluating the preparation of the financial forecast.
b. Evaluating the support underlying the assumptions.
c. Evaluating the presentation of the financial forecast for conformity with AICPA presentation guidelines.[7]
d. Issuing an examination report.

.07 Sections 700 through 720 provide guidance on engagements to examine a financial forecast.

.08 An engagement to apply agreed-upon procedures to a financial forecast is a professional service that involves—

a. Having the specified users participate in establishing the nature and scope of the engagement and take responsibility for the adequacy of the procedures to be performed by the accountant.
b. Applying the agreed-upon procedures.

5. See section 600 for the required procedures.
6. AICPA presentation guidelines are detailed in section 400.
7. AICPA presentation guidelines are detailed in section 400.

c. Issuing a report that indicates it is limited in use and intended solely for the specified users, enumerates the procedures performed, states the accountant's findings, and refers to conformity with the arrangements made with the specified users.

.09 Sections 800 through 820 provide guidance on engagements to apply agreed-upon procedures to financal forecasts.

.10 If an accountant is not engaged to compile, examine, or apply agreed-upon procedures and the financial forecast is not reasonably expected to be used by third parties, he may provide other services, such as consulting or assembly services, with respect to that forecast without having to report on such statements. Section 900 of this guide provides optional and flexible guidance to an accountant in such circumstances.

Reporting Considerations

.11 The summary of significant assumptions is essential to the user's understanding of the financial forecast. Accordingly, the accountant should not submit or report on financial forecasts that exclude disclosure of the summary of significant assumptions.

> ***.11P*** *In addition, the accountant should not submit or report on a financial projection that excludes identification of the hypothetical assumptions or a description of the limitations on the usefulness of the presentation.*

.12 The accountant may deem it inappropriate to submit or report on financial forecasts that would be misleading, for example, those with underlying assumptions that he considers inappropriate. When the accountant considers the assumptions to be inappropriate, he should follow the guidance in section 600.10(j) if he was engaged to compile the financial forecast or section 720.08 if engaged to examine the statements.

> ***.12P*** *Because a financial projection is not appropriate for general use, for example, in an offering statement of an entity's debt or equity interest, an accountant also should not submit or report on or consent to the use of his name in conjunction with a financial projection that he believes will be distributed to those who are unable to negotiate directly with the responsible party, unless the projection is used to supplement a financial forecast (see section 210.05).*

.13 In reporting on prospective financial statements the accountant may be called on to assist the responsible party in identifying assumptions, gathering information, or assembling the statements.[8] The responsible party is nonetheless responsible for the preparation and presentation of the financial forecast because the financial forecast is dependent on the actions, plans, and assumptions of the responsible party, and only it can take responsibility for the assumptions. Accordingly, the accountant's engagement should not be characterized in his report or in the document containing his report as including "preparation" of the financial forecast. An accountant may be engaged to prepare a financial analysis of a potential project where the engagement includes obtaining the information, making appropriate assumptions, and assembling the presentation. Such an analysis is not, and should not be characterized as, a forecast (*or a projection*) and would not be appropriate for general use. However, if the responsible party reviewed and adopted the assumptions and presentation, or based its assumptions and presentation on the analysis, the accountant could compile or examine the forecast and issue a report appropriate for general use.

Reasonably Objective Basis for Presentation

.14 When the accountant has been engaged to examine, compile, or apply agreed-upon procedures to a financial forecast, he should consider whether the responsible party has a reasonably objective basis for presenting a forecast (see section 400.04). In considering whether the responsible party has a reasonably objective basis, the accountant would consider whether sufficiently objective assumptions can be developed for each key factor. If the accountant is engaged to compile a forecast, he is not required to obtain or review documentation supporting the assumptions to determine if the

8. Some of these services may not be appropriate if the accountant is to be named as the person reporting on examination in a filing with the SEC. SEC Release Nos. 33–5992 and 34–15305, "Disclosure of Projections of Future Economic Performance," state that, for prospective financial statements filed with the Commission, "a person should not be named as an outside reviewer if he actively assisted in the preparation of the projection." (These releases were issued before the AICPA standards for services on prospective financial information, which defined the three levels of accountants' services described in this guide. Thus, the SEC's terminology does not correspond to that used in this guide.)

responsible party has a reasonably objective basis for the forecast. Rather, this consideration would be a factor in his considerations about whether the presentation would be misleading. Similarly, the accountant would not need to obtain or review documentation supporting the assumptions in an engagement to apply agreed-upon procedures to a forecast unless obtaining or reviewing such documentation were among the procedures requested by the user.

.14P For a financial projection, there need not be a reasonably objective basis for the hypothetical assumptions as long as they are consistent with the expected purpose and use of the projection. However, the accountant should consider that as the number and/or significance of hypothetical assumptions increase, it may be inappropriate for the responsible party to present a financial projection.

.15 The accountant should also consider that, in a forecast presented in terms of a range, as the size of the range increases, the presentation may become less meaningful, and, in some cases, it may be inappropriate to examine, compile, or apply agreed-upon procedures to it.

Change in Engagement to a Lower Level of Service

.16 An accountant who has been engaged to perform a service on a forecast may, before the completion of his engagement, be requested to change the engagement to a lower level of service. A request to change the engagement may result from a change in circumstances affecting the entity's requirement for the service, a misunderstanding as to the nature of the service or the alternative services originally available, or a restriction on the scope of the service, whether imposed by the entity or caused by circumstances.

.17 In complying with the request to change the nature of the engagement, the accountant should evaluate the possibility that information affected by the scope restriction may be inappropriate, incomplete, or otherwise misleading. If the accountant believes that the information so affected is misleading, he should try to obtain that information and consider whether a change to a lower level of service would be inappropriate and whether he should issue, for example, an adverse examination report or withdraw from the engagement. The accountant should not change his engagement to a lower level of service if he concludes the responsible party has no reasonably objective basis to present a forecast.

.18 If the engagement is changed,[9] upon completion of the engagement the accountant should issue an appropriate report. The report should not include reference to the original engagement or scope limitations that resulted in the changed engagement, or, in the case of a compilation, any examination procedures that may have been performed.

An Accountant's Responsibility When a Financial Forecast Is Included in a Document Containing Historical Financial Statements

.19 *Accountant-submitted Documents.* When an accountant's compilation, review, or examination report on historical financial statements is included in an accountant-submitted document containing a financial forecast, the accountant should either examine, compile, or apply agreed-upon procedures to the financial forecast and report accordingly, unless (a) the financial forecast is labeled as a "budget," (b) the budget does not extend beyond the end of the current fiscal year, and (c) the budget is presented with interim historical financial statements for the current year. In such circumstances, the accountant need not examine, compile, or apply agreed-upon procedures to the budget; however, he should report on it and (a) indicate that he did not examine, compile, or perform any procedures with respect to the budget and (b) disclaim an opinion or any other form of assurance on the budget. In addition, the budgeted information may omit the summaries of significant assumptions and accounting policies required by the applicable guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants, provided such omission is not, to the accountant's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such budgeted information, and is disclosed in the accountant's report. The following is the form of the standard paragraphs to be added to the

9. If the engagement is changed the accountant may deem it appropriate to establish an understanding in writing with the client as to the new service to be performed.

accountant's report in this circumstance when the summaries of significant assumptions and policies have been omitted.

> The accompanying budgeted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the six months then ending, have not been compiled or examined by us and, accordingly, we do not express an opinion or any other form of assurance.
>
> Management has elected to omit the summaries of significant assumptions and accounting policies required under established guidelines for presentation of prospective financial statements. If the omitted summaries were included in the budgeted information, they might influence the user's conclusions about the company's budgeted information. Accordingly, this budgeted information is not designed for those who are not informed about such matters.

.20 *Client-prepared Documents.* When the accountant's compilation, review, or examination report on historical financial statements is included in a client-prepared document containing a financial forecast, the accountant should not consent to the use of his name in the document unless (a) he has examined, compiled, or applied agreed-upon procedures to the financial forecast and his report accompanies it, (b) the financial forecast is accompanied by an indication by the responsible party or the accountant that the accountant has not performed such a service on the forecast[10] and that the accountant assumes no responsibility for it, or (c) another accountant has examined, compiled, or applied agreed-upon procedures to the forecast and his report is included in the document. In addition, if the accountant has examined the historical financial statements and they accompany a financial forecast that he did not examine, compile, or apply agreed-upon procedures to in certain[11] client-prepared documents, he should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements.*

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10. When an accountant has performed such a service for an SEC registrant but is precluded by the SEC from issuing such a report because he has participated in preparation of a forecast, the accountant need not state whether he has performed such a service; however, in such instances either the accountant or the responsible party should indicate that the accountant takes no responsibility for the forecast.

11. SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, applies only to such financial forecasts contained in (a) annual reports to holders of securities or beneficial interests, annual reports of organizations for char-

.21 The accountant whose report on a financial forecast is included in a client-prepared document containing historical financial statements should not consent to the use of his name in the document unless (a) he has compiled, reviewed, or examined the historical financial statements and his report accompanies them, (b) the historical financial statements are accompanied by an indication by the responsible party or the accountant that the accountant has not performed such a service on the historical financial statements and that he assumes no responsibility for them, or (c) another accountant has compiled, reviewed or examined the historical financial statements and his report is included in the document.

Other Information in a Client-prepared Document Containing a Financial Forecast

.22 An entity may publish various documents that contain information other than historical financial statements in addition to the compiled or examined financial forecast and the accountant's report thereon. The accountant's responsibility with respect to information in such a document does not extend beyond the financial information identified in the report and he has no obligation to perform any procedures to corroborate other information contained in the document. However, the accountant should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the financial forecast.

.23 The following are examples of information included in a document containing a financial forecast that would be considered materially inconsistent with the financial forecast:

a. The document includes phrases relating to the forecasted amounts such as:
   - Cannot be predicted at this time
   - Unlikely to occur
   - No prediction can be made

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itable or philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the Securities Exchange Act of 1934 or (b) other documents to which the auditor, at the client's request, devotes attention. However, SAS No. 8 does not apply when the historical financial statements and report appear in a registration statement filed under the Securities Act of 1933 (in which case, see SAS No. 37, *Filing Under Federal Securities Statutes*).

These phrases are inconsistent with the definition of a financial forecast which is based on the responsible party's assumptions reflecting conditions it expects to exist and the course of action it expects to take (section 200.04). Therefore, prospective statements in a document containing such statements should not be characterized as a forecast (see section 500.12).

b. The document describes proposed nonrecourse financing for a shopping center that will be personally guaranteed by the general partners of the limited partnership. The forecast does not disclose the guarantee by the general partners but does include an assumption that the limited partners will be able to currently deduct tax losses in excess of their capital account balances by including in each partner's basis a pro rata share of the nonrecourse partnership debt on the assumption that no partner is personally liable for such debt.

   Because the general partners are personally liable for the debt as guarantors, no portion of that debt may be allocated to the limited partners; and, under presently existing tax law, they will not be permitted to currently deduct losses in excess of the balance of their capital accounts. The forecasted deductible tax losses per limited partnership unit will have to be reduced accordingly.

.23P *The examples given above would not necessarily be inconsistent information in a document containing a financial projection (for example, a hypothetical assumption may be unlikely to occur). Although the examples may not apply, the accountant should use his judgment in determining whether information in the document is inconsistent with the presentation (see section 500.22).*

.24 If the accountant examines a financial forecast included in a document containing inconsistent information, he might not be able to conclude that there is adequate support for each significant assumption. The accountant should consider whether the forecast, his report, or both require revision. Depending on the conclusion he reaches, the accountant should consider other actions that may be appropriate, such as issuing an adverse opinion, disclaiming an opinion because of a scope limitation, withholding the use of his report in the document, or withdrawing from the engagement.

.25 If the accountant compiles a financial forecast included in the document containing inconsistent information, he should attempt to obtain additional or revised information. If he does not receive such information, the accountant should withhold the use of his report or withdraw from the compilation engagement.

.26 If, while reading the other information appearing in the document containing the examined or compiled financial forecast, as described in the preceding paragraphs, the accountant becomes aware of information that he believes is a material misstatement of fact that is not an inconsistent statement, he should discuss the matter with the responsible party. In connection with this discussion, the accountant should consider that he may not have the expertise to assess the validity of the statement made, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion. If the accountant concludes that he has a valid basis for concern, he should propose that the responsible party consult with some other party whose advice might be useful, such as the entity's legal counsel.

.27 If, after discussing the matter as described in section 500.26, the accountant concludes that a material misstatement of fact remains, the action he takes will depend on his judgment in the particular circumstances. He should consider steps such as notifying the responsible party in writing of his views concerning the information and consulting his legal counsel about further appropriate action in the circumstances.

Materiality

.28 The concept of materiality affects the application of this guide to a financial forecast as materiality affects the application of generally accepted auditing standards to historical financial statements. Materiality is a concept that is judged in light of the expected range of reasonableness of the information; therefore, users should not expect prospective information (information about events that have not yet occurred) to be as precise as historical information.

Section 510

Tax Shelter Opinions

Because a tax shelter offering document is a general use document it would be inappropriate to include in it a projection unless the projection was used to supplement a forecast. Accordingly, the guidance in this section applies only to forecasts.

.01 Included in Treasury Department regulations governing practice before the Internal Revenue Service are standards for providing tax opinions used in the promotion of tax shelter offerings (31 CFR pt. 10, published in Treasury Department Circular 230 — see Appendix D of this guide). Under these regulations an accountant's services with regard to a forecast on a "tax shelter" may be deemed to be a "tax shelter opinion."

.02 If an accountant is engaged to render services with respect to a forecast and it is not clear whether the entity is a "tax shelter," he should refer to Regulation 10.33(c)(2) (see Appendix D), which contains the definition of a "tax shelter" investment.

.03 Under Circular 230, an accountant may be deemed to be "associated" with tax shelter forecasts if he examines, compiles, assembles, or applies agreed-upon procedures with respect to such forecasts, whether or not his name is referred to in the offering materials or in connection with sales efforts, so long as such forecasts are disseminated or directed to persons other than the client who engaged the accountant.

.04 Although Circular 230 also refers to projections, as discussed in section 500.12P of this guide, an accountant may not submit or report upon a financial projection for general use (unless it supplements a forecast), for example, to solicit debt or equity financing. Also, if the accountant's services are limited to the application of agreed-upon procedures to a financial forecast, his report on the results of applying such procedures may be distributed only to specified users (section 800.01). Thus, under AICPA standards, an accountant may accept an engagement with respect to prospective financial statements for general use in connection with a "tax shelter" offering only with respect to a financial forecast upon which he will issue a compilation or examination report.

.05 An accountant who compiles a forecast in connection with a tax shelter offering may rely on the opinion of another practitioner, that is, an attorney or another accountant, concerning material tax issues, provided he has no reason to believe that the Circular 230 standards for such opinions have not been complied with by the other practitioner. If the accountant examines the forecast, he should apply the procedures in section 700.31.

.06 Tax opinions are required only on material tax issues that involve a reasonable possibility of challenge by the Internal Revenue Service. The "tax shelter opinion" should also include an overall evaluation as to whether the material tax benefits in the aggregate more likely than not will be realized. The regulations require that the opinions on each tax issue and the overall evaluation be provided only "when possible." The Supplementary Information accompanying the regulations states that ". . . Treasury expects that it will be possible to render an overall evaluation in the great majority of cases and will carefully scrutinize cases in which opinions are not expressed on each material tax issue."

.07 The Treasury regulations require that the accountant's report disclose any material tax issue not covered by, or incorrectly opined upon in, the other practitioner's opinion and set forth his own opinion with respect to each such issue in a manner that satisfies the Circular 230 requirements. These regulations do not require the accountant's report to disclose his reliance on another practitioner's opinion as to the tax assumptions underlying the forecast if the accountant believes that such opinion fully meets the requirements of Circular 230. Nevertheless, the accountant may wish to add to his compilation or examination report a reference to such tax opinion as an emphasis-of-a-matter paragraph following the standard report. The following is an example of such a paragraph:

> The Company's tax counsel, Jones and Smith, has provided an opinion on the tax assumptions on material tax issues as required by Treasury Department Circular 230. Their report, which appears on pages xx–yy of the offering document, states that, in their opinion, "it is more likely than not that the investor will prevail on the merits of each material tax issue that involves a reasonable possibility of challenge by the Internal Revenue Service and that it is more likely than not that the material tax benefits in the aggregate will be realized." The inclusion of this reference to the opinion of counsel shall not be construed, under the provisions of

Circular 230, to be the rendering of a "tax shelter opinion" by us as to the material tax issues covered by such opinion.

.08 If the accountant believes that the tax opinion rendered by another practitioner does not fully meet the Treasury standards for such opinions, he should request the responsible party to secure a revised tax opinion or revise the forecast and its underlying assumptions accordingly. Alternatively, the accountant's engagement could be expanded to include his rendering a tax opinion or a partial tax opinion that would cure the deficiencies in the opinion rendered by the other practitioner.

.09 If, in an examination, the accountant is unable to satisfy himself about the tax assumptions, he should either render an adverse opinion (section 720.05(b)) or disclaim an opinion (section 720.05(c)). If, in a compilation, the accountant believes the tax assumptions to be obviously inappropriate, incomplete, or otherwise misleading, he should withdraw from the engagement (section 600.10(j)).

.10 The accountant's "tax shelter opinion" may be presented in his compilation or examination report on the financial forecast or in a separate report. If the accountant renders such an opinion, he should be aware of the requirements of Circular 230 (see Appendix D).

Section 600

Compilation Procedures

Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. *Italicized* paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term "forecast."

.01 A compilation of a financial forecast is a professional service that involves —

a. Assembling, to the extent necessary, the financial forecast based on the responsible party's assumptions.
b. Performing the required compilation procedures,[1] including reading the financial forecast with its summaries of significant assumptions and accounting policies and considering whether they appear to be (i) presented in conformity with AICPA presentation guidelines[2] and (ii) not obviously inappropriate.
c. Issuing a compilation report.

A compilation is not intended to provide assurance on the financial forecast or the assumptions underlying it. Because of the limited nature of the accountant's procedures, a compilation does not provide assurance that the accountant will become aware of significant matters that might be disclosed by more extensive procedures, for example, those performed in an examination of a financial forecast.

.02 During the course of a compilation the accountant may assist the responsible party in identifying assumptions, gathering information, or assembling the financial forecast. In assisting his client, the accountant is not required to perform those procedures contemplated by section 300.

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1. See section 600.10 for the required procedures.
2. AICPA presentation guidelines are detailed in section 400.

.03 The following standards apply to a compilation of a financial forecast and to the resulting report:

a. The compilation should be performed by a person or persons having adequate technical training and proficiency to compile a financial forecast.

b. Due professional care should be exercised in the performance of the compilation and the preparation of the report.

c. The work should be adequately planned, and assistants, if any, should be properly supervised.

d. Applicable compilation procedures should be performed as a basis for reporting on the compiled financial forecast. (See section 600.10 for the procedures to be performed.)

e. The report based on the accountant's compilation of a financial forecast should conform to the applicable guidance in section 620.

Materiality

.04 The concept of materiality affects the application of this guide to a financial forecast as materiality affects the application of generally accepted auditing standards to historical financial statements. Materiality is a concept that is judged in light of the expected range of reasonableness of the information, and therefore users should not expect prospective information (information about events that have not yet occurred) to be as precise as historical information. For example, procedures that might otherwise normally be performed need not be performed if the effect of the procedures on the forecasted item would not be material.

Training and Proficiency

.05 The accountant should be familiar with the guidelines for the preparation and presentation of a financial forecast. The guidelines are contained in sections 300 and 400, respectively, of this guide.

Planning a Compilation Engagement

.06 The accountant should possess or obtain a level of knowledge of the industry and the accounting principles and practices of the industry in which the entity operates, or will operate, that will enable him to compile a financial forecast that is in appropriate form for an entity operating in that industry. If an accountant has no previous experience in the industry, he can obtain this level of knowledge by consulting AICPA guides, industry publications, financial statements of other entities in the industry, textbooks, periodicals, or individuals knowledgeable about the industry.

.07 To compile a financial forecast of an existing entity, the accountant should obtain a general knowledge of the nature of the entity's business transactions and the key factors upon which its future financial results appear to depend. He should also obtain an understanding of the accounting principles and practices of the entity to determine if they are comparable with those used within the industry in which the entity operates. The accountant obtains this knowledge through experience with the entity or inquiry of the entity's personnel.

.08 If the accountant has audited, reviewed, or compiled historical financial statements, or performed services on previous financial forecasts of the entity, he may already have attained familiarity with the items mentioned above.

.09 To compile a financial forecast of a proposed entity, the accountant should obtain knowledge of the proposed operations and the key factors upon which its future results appear to depend and that have affected the performance of entities in the same industry. The accountant can obtain this knowledge in the same manner as described in section 600.06.

Compilation Procedures

.10 In performing a compilation of a financial forecast the accountant should, where applicable —

a. Establish an understanding with the client, preferably in writing, regarding the services to be performed. (Excerpts from example engagement letters appear in section 610.)

b. Inquire about the accounting principles used in the preparation of the financial forecast.

   (i) For existing entities, compare the accounting principles used to those used in the preparation of previous historical financial statements and inquire whether such principles are the same as those expected to be used in the historical financial statements covering the forecast period.

   (ii) For entities to be formed or entities formed that have not commenced operations, compare specialized industry accounting principles used, if any, to those typically used in the industry. Inquire about whether the accounting principles used for the financial forecast are those that are expected to be used when, or if, the entity commences operations.

c. Ask how the responsible party identifies the key factors and develops its assumptions.
d. List or obtain a list of the responsible party's significant assumptions providing the basis for the financial forecast and consider whether there are any obvious omissions in light of the key factors upon which the prospective results of the entity appear to depend.
e. Consider whether there appear to be any obvious internal inconsistencies in the assumptions.
f. Perform, or test the mathematical accuracy of, the computations that translate the assumptions into the financial forecast.
g. Read the financial forecast, including the summary of significant assumptions, and consider whether —
   (i) The forecast, including the disclosures of assumptions and accounting policies, appears to be presented in conformity with the AICPA presentation guidelines for a financial forecast, which appear in section 400.
   (ii) The forecast, including the summary of significant assumptions, appears to be not obviously inappropriate in relation to —
      (a) The accountant's knowledge of the entity and its industry.
      (b) The expected conditions and course of action in the forecast period.

   .10(g)(ii)P *The accountant should also consider whether the projection appears to be obviously inappropriate in relation to the special purpose of the presentation.*

h. If a significant part of the prospective period has expired, inquire about the results of operations or significant portions of the operations (such as sales volume) and significant changes in financial position, and consider their effect in relation to the financial forecast. If historical financial statements have been prepared for the expired portion of the period, the accountant should read such statements and consider those results in relation to the financial forecast.

i. Confirm his understanding of the forecast (including assumptions) by obtaining written representations from the responsible party. Because the amounts reflected in the forecast are not supported by historical books and records but rather by assumptions, the accountant should obtain representations in which the responsible party indicates its responsibility for the assumptions. The representations should be signed by the responsible party at the highest level of authority who the accountant believes is responsible for and knowledgeable, directly or through others, about matters covered by the representations. The representations should include a statement that the financial forecast presents, to the best of the responsible party's knowledge and belief, the expected financial position, results of operations, and changes in financial position for the forecast period and that the forecast reflects the responsible party's judgment, based on present circumstances, of the expected conditions and its expected course of action. If the forecast contains a range, the representations should also include a statement that, to the best of the responsible party's knowledge and belief, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

.10(i)P The accountant should confirm his understanding of the projection (including assumptions) by obtaining written representations from the responsible party. Because the amounts reflected in the statements are not supported by historical books and records but rather by assumptions, the accountant should obtain representations in which the responsible party indicates its responsibility for the assumptions. The representations should be signed by the responsible party at the highest level of authority who the accountant believes is responsible for and knowledgeable, directly or through others, about matters covered by the representations. The representations should include a statement that the financial projection presents, to the best of the responsible party's knowledge and belief, the expected financial position, results of operations, and

changes in financial position for the projection period given the hypothetical assumptions, *and that the projection reflects its judgment, based on present circumstances, of expected conditions and its expected course of action given the occurrence of the hypothetical events. The representations should also (1) identify the hypothetical assumptions and describe the limitations on the usefulness of the presentation, (2) state that the assumptions are appropriate, (3) indicate if the hypothetical assumptions are improbable, and (4) if the projection contains a range, the representations should also include a statement that, to the best of the responsible party's knowledge and belief, given the hypothetical assumptions, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.*

j. Consider, after applying the above procedures, whether he has received representations or other information that appears to be obviously inappropriate, incomplete, or otherwise misleading and, if so, attempt to obtain additional or revised information. If he does not receive such information, the accountant should ordinarily withdraw from the compilation engagement.[3] (Note that the omission of disclosures, other than those relating to significant assumptions, would not require the accountant to withdraw; see section 620.09.)

Working Papers

.11 Although it is not possible to specify the form or content of the working papers that an accountant should prepare in connection with a compilation of a financial forecast because of the different circumstances of individual engagements, the accountant's working papers ordinarily should indicate that —

a. The work was adequately planned and supervised.
b. The required compilation procedures were performed as a basis for the compilation report.

.12 Some accountants use a checklist or work program similar to

3. The accountant need not withdraw from the engagement if the effect of such information on the financial forecast does not appear to be material.

that shown in section 600.10 to document the items discussed in section 600.11. The inclusion of the checklist would frequently be sufficient documentation of planning, and signing off after completion of procedures would ordinarily be sufficient documentation of performance.

Section 610

Illustrative Engagement and Representation Letters for a Compilation

Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. *Italicized* paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term "forecast."

Engagement Letter

.01 The following is an excerpt from a sample engagement letter for a compilation of a financial forecast.[1]

> This letter sets forth our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.
>
> We will compile, in accordance with standards established by the American Institute of Certified Public Accountants, from information management[2] provides, the forecasted balance sheet and related statements of income, retained earnings, changes in financial position and summaries of significant assumptions and accounting policies of XYZ Company as of December 31, 19XX, and for the year then ending. We will not express any form of assurance on the achievability of the forecast or reasonableness of the underlying assumptions.
>
> A compilation of a financial forecast involves assembling the forecast based on management's assumptions and performing certain other pro-

1. If the assumptions regarding income taxes are sensitive, for example in a tax shelter offering, the accountant may wish his engagement letter to provide that the client will obtain a "tax opinion" from its counsel or that the accountant will undertake to apply those procedures necessary to satisfy himself about the tax assumptions. Treasury Department Circular 230 establishes certain requirements regarding such opinions. See Appendix D.

2. If the responsible party is other than management, the references to management should be replaced with the name of the party who assumes responsibility for the assumptions.

cedures with respect to the forecast without evaluating the support for, or expressing an opinion or any other form of assurance on, the assumptions underlying it.

If for any reason we are unable to complete our compilation of your financial forecast, we will not issue a report on it as a result of this engagement.

A financial forecast presents, to the best of management's knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the forecast period. It is based on management's assumptions, reflecting conditions it expects to exist and the course of action it expects to take during the forecast period.

Management is responsible for representations about its plans and expectations and for disclosure of significant information that might affect the ultimate realization of the forecasted results.

There will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. Our report will contain a statement to that effect.

We have no responsibility to update our report for events and circumstances occurring after the date of such report.

At the conclusion of the engagement, management agrees to supply us with a representation letter which, among other things, will confirm management's responsibility for the underlying assumptions and appropriateness of the financial forecast and its presentation.

In order for us to complete this engagement, management must provide assumptions that are appropriate for the forecast. If the assumptions provided are inappropriate and have not been revised to our satisfaction we will be unable to complete the engagement, and, accordingly, we will not issue a report on the forecast.

If management intends to reproduce and publish the forecast and our report thereon, they must be reproduced in their entirety, and both the first and subsequent corrected drafts of the document containing the forecast and any accompanying material must be submitted to us for approval.

.01P *The following is an excerpt from a sample engagement letter on a compilation of a financial projection.*

This letter sets forth our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will compile, in accordance with standards established by the

American Institute of Certified Public Accountants, from information management[3] provides, the projected balance sheet and related statements of income, retained earnings, changes in financial position, and summaries of significant assumptions and accounting policies of XYZ Company as of December 31, 19XX, and for the year then ending. We will not express any form of assurance on the achievability of the projection or reasonableness of the underlying assumptions.

A compilation of a financial projection involves assembling the projection based on management's assumptions and performing certain other procedures with respect to the projection without evaluating the support for, or expressing an opinion or any other form of assurance on, the assumptions underlying it.

If for any reason we are unable to complete our compilation of your financial projection, we will not issue a report on it as a result of this engagement.

The financial projection presents, to the best of management's knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the projection period assuming [describe hypothetical assumptions]. *It is based on management's assumptions reflecting conditions it expects would exist and courses of action it expects would be taken during the projection period assuming* [describe hypothetical assumptions].

Management is responsible for representations about its plans and expectations and for disclosure of significant information that might affect the ultimate realization of the projected results.

Even if [describe hypothetical assumptions] *were to occur, there will usually be differences between projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. Our report will contain a statement to that effect.*

We have no responsibility to update our report for events and circumstances occurring after the date of such report.

At the conclusion of the engagement, management agrees to supply us with a representation letter which, among other things, will confirm management's responsibility for the underlying assumptions and appropriateness of the financial projection and its presentation.

In order for us to complete this engagement, management must pro-

3. If the responsible party is other than management, the references to management should be replaced with the name of the party who assumes responsibility for the assumptions.

vide assumptions that are appropriate for the projection. If the assumptions provided are inappropriate and have not been revised to our satisfaction, we will be unable to complete the engagement and, accordingly, we will not issue a report on the projection.

We understand that the projection and our report thereon will be used only for [state intended limited use]. *If management intends to reproduce the projection and our report thereon, they must be reproduced in their entirety and both the first and subsequent corrected drafts of the document containing the projection and any accompanying material must be submitted to us for approval.*

Representation Letter

.02 The following is an illustrative representation letter for an engagement to compile a financial forecast. The written representations to be obtained should be based on the circumstances.

[*Date of Accountant's report*]

[*Accountant's name*]

In connection with your compilation of the forecasted balance sheet and related statements of income, retained earnings, and changes in financial position and summaries of significant assumptions and accounting policies of XYZ Company as of December 31, 19XX, and for the year then ending, we make the following representations:

1. The financial forecast presents our assumptions and, to the best of our knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the period[4] in conformity with the generally accepted accounting principles expected to be used by the company during the forecast period, which are consistent with the principles XYZ Company uses in preparing its historical financial statements.
2. The financial forecast is based on our judgment of the expected conditions and our expected course of action.
3. We have made available to you all significant information that we believe is relevant to the forecast.
4. We believe that the assumptions underlying the forecast are reasonable and appropriate.
5. To the best of our knowledge and belief, the documents and records supporting the assumptions are appropriate.

[*Signatures*]

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4. If the forecast is presented as a range, the description of the projection would refer to the range, for example, "... at occupancy rates of 75 and 95 percent."

.02P The following is an illustrative representation letter for an engagement to compile a financial projection. The written representations to be obtained should be based on the circumstances.

[Date of Accountant's report]

[Accountant's name]

In connection with your compilation of the projected balance sheet and related statements of income, retained earnings, and changes in financial position and summaries of significant assumptions assuming [describe hypothetical assumptions] *and accounting policies of XYZ Company as of December 31, 19XX, and for the year then ending, we make the following representations:*

1. *The financial projection presents our assumptions and, to the best of our knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the projection period assuming* [describe the hypothetical assumptions].[5]
2. *The accounting principles used in the financial projection are in accordance with the generally accepted accounting principles expected to be used by the Company during the projection period, which are consistent with the principles XYZ Company uses in preparing its historical financial statements.*[6]
3. *The financial projection is based on our judgment, considering present circumstances, of the expected conditions and our expected course of action assuming* [describe hypothetical assumptions].
4. *We have made available to you all significant information that we believe is relevant to the financial projection.*
5. *We believe that the assumptions underlying the projection are appropriate and reasonable assuming* [describe hypothetical assumptions].
6. *To the best of our knowledge and belief, the documents and records supporting the assumptions are appropriate.*
7. *We intend to use this projection only for* [describe intended limited use].

[Signatures]

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5. If the projection is presented as a range, the description of the projection would refer to the range, for example, "... at occupancy rates of 75 and 95 percent."

6. If the projection is not presented on the basis of the accounting principles used for the historical financial statements, this sentence might read "The accounting principles used in the financial projection are consistent with [*the special purpose of the projection*]."

.03 If the forecast is presented as a range, the following representation would be added:

> We reasonably expect that the actual [*describe items presented as a range*] achieved will be within the range shown; however, there can be no assurances that it will. The range shown was not selected in a biased or misleading manner.

> ***.03P*** *If the presentation is presented as a range, the following representation would be added:*

> *We reasonably expect that the actual* [describe items presented as a range] *achieved will be within the range shown assuming* [describe hypothetical assumption]*; however, there can be no assurance that it will. The range shown was not selected in a biased or misleading manner.*

.04 If the date of the signed representations is later than the date of the preparation of the forecast (see section 400.11), the following representation would be added:

> We are not aware of any material changes in the information or circumstances from [*date*], the date of the forecast, to the present.

Section 620

The Accountant's Compilation Report

Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. *Italicized* paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term "forecast."

.01 The accountant's standard report on a compilation of a financial forecast should include—

a. An identification of the financial forecast presented by the responsible party.
b. A statement that the accountant has compiled the financial forecast in accordance with standards established by the American Institute of Certified Public Accountants.
c. A statement that a compilation is limited in scope and does not enable the accountant to express an opinion or any other form of assurance on the financial forecast or the assumptions.
d. A caveat that the forecasted results may not be achieved.
e. A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

.01P *When reporting on a compiled financial projection, the accountant should add to the items discussed in section 620.01 a paragraph that describes the limitations on the usefulness of the presentation.*

.02 The following is the form of the accountant's standard report on the compilation of a forecast that does not contain a range.[1]

1. The forms of reports provided in this guide are appropriate whether the presentation is based on generally accepted accounting principles or on another comprehensive basis of accounting.

We have compiled the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending, in accordance with standards established by the American Institute of Certified Public Accountants.[2]

A compilation is limited to presenting in the form of a forecast information that is the representation of management[3] and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.02P *The following is the form of the accountant's standard report on a compilation of a projection that does not contain a range.*

We have compiled the accompanying projected balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending, in accordance with standards established by the American Institute of Certified Public Accountants.[4]

The accompanying projection and this report were prepared for [state special purpose, for example, "the DEF National Bank for the purpose of negotiating a loan to expand XYZ Company's plant"] *and should not be used for any other purpose.*

A compilation is limited to presenting in the form of a projection information that is the representation of management and does not include

2. When the presentation is summarized as discussed in section 400.06, this sentence might read "We have compiled the accompanying summarized forecast of XYZ Company as of December 31, 19XX, and for the year then ending, in accordance with standards established by the American Institute of Certified Public Accountants."

3. When the responsible party is other than management, the references to management in the standard reports provided in this guide should be changed to refer to the party who assumes responsibility for the assumptions.

4. When the presentation is summarized as discussed in section 400.06, this sentence might read "We have compiled the accompanying summarized forecast of XYZ Company as of December 31, 19XX, and for the year then ending, in accordance with standards established by the American Institute of Certified Public Accountants."

evaluation of the support for the assumptions underlying the projection. We have not examined the projection and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, even if [describe hypothetical assumption, for example, "the loan is granted and the plant is expanded"] *there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.*

.03 When the financial forecast contains a range, the accountant's standard report should also include a separate paragraph that states that the responsible party has elected to portray the expected results of one or more assumptions as a range. The following is an example of the separate paragraph to be added to the accountant's report when he compiles a forecast that contains a range:

As described in the summary of significant assumptions, management of XYZ Company has elected to portray forecasted [*describe financial statement element or elements for which the expected results of one or more assumptions fall within a range, and identify the assumptions expected to fall within a range, for example, "revenue at the amounts of $X,XXX and $Y,YYY, which is predicated upon occupancy rates of XX percent and YY percent of available apartments"*] rather than as a single-point estimate. Accordingly, the accompanying forecast presents forecasted financial position, results of operations and changes in financial position [*describe one or more assumptions expected to fall within a range, for example, "at such occupancy rates."*] However, there is no assurance that the actual results will fall within the range of [*describe one or more assumptions expected to fall within a range, for example, "occupancy rates"*] presented.

.04 The date of completion of the accountant's compilation procedures should be used as the date of the report.

.05 An accountant may compile a financial forecast for an entity with respect to which he is not independent.[5] In such circumstances, the accountant should specifically disclose his lack of inde-

5. In making a judgment about whether he is independent, the accountant should be guided by the AICPA Code of Professional Ethics. Also, see the auditing interpretation "Applicability of Guidance on Reporting When Not Independent" (AICPA, *Professional Standards*, vol. 1, AU section 9504.19–.22).

pendence; however, the reason for the lack of independence should not be described. When the accountant is not independent, he may give the standard compilation report but should include the following sentence after the last paragraph.

We are not independent with respect to XYZ Company.

.06 A financial forecast may be included in a document that also contains historical financial statements and the accountant's report thereon.[6] In addition, the historical financial statements that appear in the document may be summarized and presented with the financial forecast for comparative purposes.[7] An example of the reference to the accountant's report on the historical financial statements when he examined, reviewed, or compiled those statements is presented below.

(concluding sentence of last paragraph)

The historical financial statements for the year ended December 31, 19XX (from which the historical data are derived) and our report thereon are set forth on pages xx–yy of this document.

.07 In some circumstances, an accountant may wish to expand his report to emphasize a matter regarding the financial forecast. Such information may be presented in a separate paragraph of the accountant's report. However, the accountant should exercise care that emphasizing such a matter does not give the impression that he is expressing assurance or expanding the degree of responsibility he is taking with respect to such information.[8] For example, the accountant should not include statements in his compilation report about the mathematical accuracy of the statements or their conformity with presentation guidelines.

6. The accountant's responsibility with respect to those historical financial statements upon which he is not engaged to perform a professional service is described in SAS No. 26, *Association With Financial Statements*, in the case of public entities, and Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements*, paragraphs 5 through 7, in the case of nonpublic entities.

7. SAS No. 42, *Reporting on Condensed Financial Statements and Selected Financial Data*, discusses the accountant's report where summarized financial statements are derived from audited statements that are not included in the same document.

8. However, the accountant may provide assurance on tax matters in order to comply with the requirements of regulations governing practice before the Internal Revenue Service contained in 31 CFR pt. 10 (Treasury Department Circular 230).

.08 If the accountant compiles a financial forecast in conjunction with an examination of the forecast, he need only report on the examination.

Modifications of the Standard Compilation Report

.09 An entity may request an accountant to compile a financial forecast that contains presentation deficiencies or omits disclosures other than those relating to significant assumptions. The accountant may compile such a financial forecast provided the deficiency or omission is clearly indicated in his report and is not, to his knowledge, undertaken with the intention of misleading those who might reasonably be expected to use the forecast.

.10 Notwithstanding the above, if the compiled financial forecast is presented on a comprehensive basis of accounting other than generally accepted accounting principles and does not include disclosure of the basis of accounting used, the basis should be disclosed in the accountant's report.

.11 The following is an example of a paragraph that should be added to a report on a compiled financial forecast in which the summary of significant accounting policies has been omitted.

> Management has elected to omit the summary of significant accounting policies required by the guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants. If the omitted disclosures were included in the forecast, they might influence the user's conclusions about the Company's financial position, results of operations, and changes in financial position for the forecast period. Accordingly, this report is not designed for those who are not informed about such matters.

Other Reporting Examples

.12 The following is an example of a report on compilations of a financial forecast shown as a single-point estimate for one period and a forecast that contains a range for a later period.

> We have compiled the accompanying forecasted balance sheets, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19X1 and 19X2, and for the years then ending, in accordance with standards established by the American Institute of Certified Public Accountants.
>
> A compilation is limited to presenting in the form of a forecast informa-

tion that is the representation of management and does not include evaluation of the support for the assumptions underlying the forecasts. We have not examined the forecasts and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

As described in the summary of significant assumptions, management of XYZ Company has, for 19X2, elected to portray forecasted [*describe financial statement element or elements for which the expected results of one or more assumptions fall within a range, and identify the assumptions expected to fall within a range, for example, "revenue at amounts of $X,XXX and $Y,YYY, which is predicated upon occupancy rates of XX percent and YY percent of available apartments"*] rather than as a single-point estimate. Accordingly, the 19X2 forecast presents forecasted financial position, results of operations and changes in financial position [*describe one or more assumptions expected to fall within a range, for example, "at such occupancy rates"*]. However, there is no assurance that the actual results will fall within the range of [*describe one or more assumptions expected to fall within a range, for example, "occupancy rates"*] presented.

.13 The following is an example of an accountant's report when he is engaged to examine[9] a forecast for one period and compile a forecast for a later period.

We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19X1, and for the year then ending. Our examination was made in accordance with standards for an examination of a forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.

In our opinion the aforementioned forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants and the underlying assumptions provide a reasonable basis for management's forecast.

We have compiled the accompanying forecasted balance sheet, state-

9. See section 720.

ments of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19X2, and for the year then ending, in accordance with standards established by the American Institute of Certified Public Accountants. A compilation is limited to presenting in the form of a forecast information that is the representation of management and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast as of December 31, 19X2, and for the period then ending and, accordingly, do not express an opinion or any other form of assurance on the forecast or assumptions.

For both years presented there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Section 700

Examination Procedures

Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. *Italicized* paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term "forecast."

.01 An examination of a financial forecast is a professional service that involves—

a. Evaluating the preparation of the financial forecast.
b. Evaluating the support underlying the assumptions.
c. Evaluating the presentation of the financial forecast for conformity with AICPA presentation guidelines.[1]
d. Issuing an examination report.

.02 As a result of his examination, the accountant has a basis for reporting on whether, in his opinion—

a. The financial forecast is presented in conformity with AICPA guidelines.
b. The assumptions provide a reasonable basis for the responsible party's forecast.

.02P *As a result of his examination the accountant has a basis for reporting on whether a financial projection is presented in conformity with AICPA guidelines and whether the assumptions provide a reasonable basis for the responsible party's presentation*, given the hypothetical assumptions.

.03 During the course of the examination the accountant may assist the responsible party in identifying assumptions, gathering information, or assembling the financial forecast. In assisting his cli-

1. AICPA presentation guidelines are detailed in section 400.

ent, the accountant is not required to perform those procedures contemplated by section 300.

.04 The accountant should be independent;[2] have adequate technical training and proficiency to examine a financial forecast; adequately plan the engagement and supervise the work of assistants, if any; and obtain sufficient evidence to provide a reasonable basis for his examination report. This section contains standards concerning such technical training and proficiency (sections 700.06–.07), planning an examination engagement (sections 700.08–.11), and the types of procedures an accountant should perform to obtain sufficient evidence for his examination report (sections 700.12–.37).

Materiality

.05 The concept of materiality affects the application of this guide to a financial forecast as materiality affects the application of generally accepted auditing standards to historical financial statements. Materiality is a concept that is judged in light of the expected range of reasonableness of the information, and therefore users should not expect prospective information (information about events that have not yet occurred) to be as precise as historical information. For example, procedures that might otherwise normally be performed need not be performed if the effect of the procedures on the forecasted item would not be material.

Training and Proficiency

.06 The accountant should be familiar with the guidelines for the preparation and presentation of a financial forecast. The guidelines are contained in sections 300 and 400, respectively, of this guide.

.07 The accountant should possess or obtain a level of knowledge of the industry and the accounting principles and practices of the industry in which the entity operates, or will operate, that will enable him to examine a financial forecast that is in appropriate form for an entity operating in that industry.

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2. In making a judgment about whether he is independent, the accountant should be guided by the AICPA Code of Professional Ethics. Also see the auditing interpretation "Applicability of Guidance on Reporting When Not Independent" (AICPA, *Professional Standards*, vol. 1, AU section 9504.19 –.22).

Planning an Examination Engagement

.08 Planning the examination engagement involves developing an overall strategy for the expected scope and conduct of the engagement. To develop such a strategy, the accountant needs to have sufficient knowledge to enable him to adequately understand the events, transactions, and practices that, in his judgment, may have a significant effect on the financial forecast.

.09 Factors to be considered by the accountant in planning the examination include (a) the accounting principles to be used and the type of presentation, (b) the anticipated level of attestation risk[3] related to the financial forecast, (c) preliminary judgments about materiality levels, (d) items within the financial forecast that are likely to require revision or adjustment, (e) conditions that may require extension or modification of the accountant's examination procedures, (f) knowledge of the entity's business and its industry, (g) the responsible party's experience in preparing financial forecasts, (h) the length of the period covered by the financial forecast, and (i) the process by which the responsible party develops its financial forecast.

.10 The accountant should obtain knowledge of the entity's business, accounting principles, and the key factors upon which its future financial results appear to depend in a manner similar to that described in sections 600.06 –.09. The accountant should focus on such areas as—

a. The availability and cost of resources needed to operate. Principal items usually include raw materials, labor, short-term and long-term financing, and plant and equipment.
b. The nature and condition of markets in which the entity sells its goods or services, including final consumer markets if the entity sells to intermediate markets.

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3. Attestation risk is the risk that the accountant may unknowingly fail to appropriately modify his examination report on a financial forecast that is materially misstated; that is, that is not presented in conformity with AICPA presentation guidelines or has assumptions that do not provide a reasonable basis for management's forecast (*or do not provide a reasonable basis for management's projection, given the hypothetical assumptions*). It consists of (a) the risk (consisting of inherent risk and control risk) that the financial forecast contains errors that could be material, and (b) the risk (detection risk) that the accountant will not detect such errors.

c. Factors specific to the industry, including competitive conditions, sensitivity to economic conditions, accounting policies, specific regulatory requirements, and technology.

d. Patterns of past performance for the entity or comparable entities, including trends in revenue and costs, turnover of assets, uses and capacities of physical facilities, and management policies.

.11 If the accountant has reviewed or examined the entity's historical financial statements or performed services on previous financial forecasts, he may be generally familiar with certain of these areas.[4] However, the accountant may acquire or augment this knowledge in other ways, such as by inquiry of entity personnel, by experience with other similar entities in the industry, by consultation with individuals knowledgeable about the industry, and by use of industry publications, financial statements of other entities in the industry, textbooks, and periodicals.

Examination Procedures

.12 The accountant and the responsible party should reach an understanding regarding the services to be provided. Ordinarily, this understanding is confirmed in an engagement letter. (An excerpt from an illustrative engagement letter is presented in section 710.)

.13 The accountant's objective in an examination of a financial forecast is to accumulate sufficient evidence to limit attestation risk to a level that is, in his professional judgment, appropriate for the level of assurance that may be imparted by his examination report. In a report on an examination of a financial forecast, he provides assurance only about whether the forecast is presented in conformity with AICPA presentation guidelines and whether the assumptions provide a reasonable basis for management's forecast. He does not provide assurance about the achievability of the prospective results, because events and circumstances frequently do not occur

4. See SAS No. 22, *Planning and Supervision*, paragraphs 7 and 8, and SSARS No. 1, *Compilation and Review of Financial Statements*, paragraphs 24 through 26.

as expected and achievement of the prospective results is dependent on the actions, plans, and assumptions of the responsible party.

.13P In a report on an examination of a projection, the accountant provides assurance on whether the assumptions provide a reasonable basis for the projection, given the hypothetical assumptions.

.14 In his examination of a financial forecast, the accountant should select from all available procedures — that is, procedures that assess inherent and control risk and restrict detection risk — any combination that can limit attestation risk to such an appropriate level. The extent to which examination procedures will be performed should be based upon the accountant's consideration of (a) the nature and materiality of the information to the financial forecast taken as a whole, (b) the likelihood of misstatements, (c) knowledge obtained during current and previous engagements, (d) the responsible party's competence with respect to financial forecasts, (e) the extent to which the financial forecast is affected by the responsible party's judgment, for example, its judgment in selecting the assumptions used to prepare the financial forecast, and (f) the adequacy of the responsible party's underlying data.

The Responsible Party's Experience in Preparing Financial Forecasts

.15 Analysis of any financial forecasts developed for past periods compared to the historical results for those periods may indicate the effectiveness of the process to prepare financial forecasts. However, the responsible party's previous experience is not necessarily indicative of the reliability of the forecast under examination.

Prospective Period

.16 The accountant should consider the length of the prospective period[5] and the extent to which historical results for part of the prospective period are included in the forecast. These two factors may affect the amount and reliability of support for the assumptions underlying the financial forecast.

5. See sections 400.32–.33.

Process by Which the Responsible Party Develops Its Financial Forecasts

.17 The accountant's understanding of the process helps determine the scope of the examination. The accountant's initial understanding usually is obtained in discussions with personnel responsible for the presentation. More detailed understanding, including the process by which the key factors are identified and assumptions are developed, reviewed, and approved, is generally obtained through inquiry; observation; review of manuals, memoranda, instructions, and forms used (if any); analysis of models and statistical techniques (if used); and review of documentation. The extent to which the accountant obtains or develops documentation in support of the assumptions will depend upon the complexity of the process.

.18 In determining the scope of his examination the accountant should consider the process in relation to the guidance in section 300.[6]

Procedures to Evaluate Assumptions

.19 The accountant should perform those procedures he considers necessary in the circumstances to report on whether the assumptions provide a reasonable basis for the financial forecast. The accountant can form an opinion that the assumptions provide a reasonable basis for the forecast if the responsible party represents that the presentation reflects, to the best of its knowledge and belief, its estimate of expected financial position, results of operations, and changes in financial position for the forecast period[7] and the accountant concludes, based on his examination, (a) that the responsible party has explicitly identified all factors expected to materially affect the operations of the entity during the forecast period and has

6. The accountant's consideration of the process may also provide a basis for constructive suggestions concerning improvements in the process used to develop financial forecasts.

7. If the forecast contains a range, the representation should also include a statement that, to the best of the responsible party's knowledge and belief, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

developed appropriate assumptions with respect to such factors[8] and (b) that the assumptions are suitably supported (see section 700.23).

.19P *In an examination of a financial projection, the accountant should perform those procedures he considers necessary in the circumstances to report whether the assumptions provide a reasonable basis for the financial projection* given the hypothetical assumptions. *The accountant can form an opinion that the assumptions provide a reasonable basis for the financial projection given the hypothetical assumptions if the responsible party represents that the presentation reflects, to the best of its knowledge and belief, expected financial position, results of operations, and changes in financial position for the prospective period given the hypothetical assumptions*[9] *and the accountant concludes, based on his examination, (a) that the responsible party has explicitly identified all factors that would materially affect the operations of the entity during the prospective period if the hypothetical assumptions were to materialize and has developed appropriate assumptions with respect to such factors and (b) that the other assumptions are suitably supported given the hypothetical assumptions. However, as the number and significance of the hypothetical assumptions increase, the accountant may not be able to satisfy himself about the presentation as a whole by obtaining support for the remaining assumptions.*

Development of Assumptions

.20 Using his knowledge of the business, the accountant should evaluate whether assumptions have been developed for all key factors upon which the entity's financial results appear to depend. In evaluating the assumptions, the accountant should consider the relevance and overall completeness of the factors identified, as well as

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8. An attempt to list all assumptions is inherently not feasible. Frequently, basic assumptions that have enormous potential impact are considered to be implicit, such as conditions of peace and absence of natural disasters.

9. If the projection contains a range, the representation should also include a statement that, to the best of the responsible party's knowledge and belief, given the hypothetical assumptions, the item or items subject to the assumptions are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

risks inherent in the business and the sensitivity of the financial forecast to variations in particular assumptions.

.21 Analyzing prior-period financial statements may help identify the principal factors that influence financial results. The accountant should consider whether any significant deviations from historical trends exist, including deviations from historical results included for a part of the prospective period. The deviations might highlight significant factors that previously were not deemed important to the business.

Support for Assumptions

.22 Having satisfied himself that all key factors have been identified and assumptions have been developed for each key factor, the accountant should evaluate support for assumptions.

.23 The accountant can conclude that assumptions are suitably supported if the preponderance of information supports each significant assumption.

> ***.23P*** *For a financial projection, in evaluating support for assumptions other than hypothetical assumptions, the accountant can conclude that they are suitably supported if the preponderance of information supports each significant assumption* given the hypothetical assumptions. *The accountant need not obtain support for the hypothetical assumptions, although he should consider whether they are consistent with the purpose of the presentation.*

.24 As used here, "preponderence" is not meant to imply that a statistical majority of available information points to a specific assumption. Rather, a preponderance of information exists for an assumption if the weight of available information tends to support that assumption. Further, because of the judgments involved in developing assumptions, different people may arrive at somewhat different but equally reasonable assumptions based on the same information.

.25 In his evaluation of whether the assumptions provide a reasonable basis for the forecast, the accountant should consider the assumptions in the aggregate. If certain assumptions have no material impact on the presentation, they may not have to be individually evaluated. Nonetheless, the accountant should consider the aggregate impact of individually insignificant assumptions in making his overall evaluation.

.26 The financial forecast the accountant is engaged to examine is defined in terms of the responsible party's estimate, to the best of its knowledge and belief, of expected future results based on expected conditions and courses of action. Although the accountant can reach a conclusion that the assumptions provide a reasonable basis for the presentation, he cannot conclude that any outcome is expected because (a) realization of the financial forecast may depend upon the responsible party's intentions, which cannot be examined, (b) there is substantial inherent uncertainty in the assumptions, (c) some of the information accumulated about an assumption may appear contradictory, and (d) different but similarly reasonable assumptions concerning a particular matter might be derived from common information.

.27 The accountant should concentrate his effort on specific assumptions that are —

a. Material to the prospective amounts.
b. Especially sensitive to variations.
c. Deviations from historical trends.
d. Especially uncertain.

.28 In evaluating the support for assumptions, the accountant should consider —

a. Whether sufficient pertinent sources of information about the assumptions have been considered. Examples of external sources the accountant might consider are government publications, industry publications, economic forecasts, existing or proposed legislation, and reports of changing technology. Examples of internal sources are budgets, labor agreements, patents, royalty agreements and records, sales backlog records, debt agreements, and actions of the board of directors involving entity plans.
b. Whether the assumptions are consistent with the sources from which they are derived.
c. Whether the assumptions are consistent with each other.
d. Whether the historical financial information and other data

used in developing the assumptions are sufficiently reliable for that purpose. Reliability can be assessed by inquiry and analytical or other procedures, some of which may have been completed in past examinations or reviews of the historical financial statements. If historical financial statements have been prepared for an expired part of the prospective period, the accountant should consider the historical data in relation to the prospective results for the same period, where applicable. If the financial forecast incorporates such historical financial results and that period is significant to the presentation, the accountant should make a review of the historical information in conformity with the applicable standards for a review.[10]

e. Whether the historical financial information and other data used in developing the assumptions are comparable over the periods specified or whether the effects of any lack of comparability were considered in developing the assumptions.

f. Whether the logical arguments or theory, considered with the data supporting the assumptions, are reasonable.

.29 Support for assumptions may include market surveys, engineering studies, general economic indicators, industry statistics, trends and patterns developed from an entity's operating history, and internal data and analyses, accompanied by their supporting logical argument or theory. The accountant may also obtain support during the evaluation of the process by which the responsible party develops its financial forecasts. Support can range from information based on informed opinion (such as economists' estimates of the inflation rate) to data that can be tested in traditional ways (such as completed transactions).

.30 In addition to evaluating the assumptions and the sources of information used to develop them, the accountant should consider using alternative approaches to the development of assumptions in evaluating forecasted amounts. For example, to test a forecast of

10. If the entity is a public company, the accountant should perform the procedures in SAS No. 36, *Review of Interim Financial Information*, paragraphs 6 through 15. If the entity is nonpublic, the accountant should perform the procedures in SSARS No. 1, *Compilation and Review of Financial Statements*, paragraphs 24 through 31.

aggregate sales developed from individual salesmen's estimates the accountant may employ a historical trend estimate.

Support for Tax Assumptions

.31 Sometimes, one of the most sensitive assumptions underlying a financial forecast relates to the income tax treatment of prospective transactions. This is usually the case for financial forecasts used for tax shelter offerings.[11] Where this is the case the accountant should satisfy himself as to the appropriateness of the tax assumptions either (a) through his own inquiry and analysis or (b) by obtaining an opinion about those tax consequences (a "tax opinion") rendered by the entity's tax counsel or another accountant and applying the procedures in SAS No. 11, *Using the Work of a Specialist*, paragraphs 5 through 8. The tax assumptions would be appropriate only in those situations where the accountant is satisfied with respect to each material issue, individually and in the aggregate, that the tax consequences are "more likely than not" the proper tax treatment.

Evaluating Preparation and Presentation

.32 In evaluating the preparation and presentation of the financial forecast, the accountant should perform procedures that will provide reasonable assurance that the —

a. Presentation reflects the identified assumptions.
b. Computations made to translate the assumptions into prospective amounts are mathematically accurate.
c. Assumptions are internally consistent.
d. Accounting principles used in the financial forecast are consistent with the accounting principles expected to be used in the historical financial statements covering the prospective period and those used in the most recent historical financial statements, if any.

   .32(d)P Accounting principles used in the financial projection are consistent with the accounting principles expected

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11. The accountant should be aware of Treasury Department Circular 230, involving tax shelter opinions (see Appendix D), which establishes certain requirements regarding the accountant's consideration of tax assumptions in tax shelter offering materials. Also see section 510, "Tax Shelter Opinions," in this guide.

to be used in the prospective period and those used in the most recent historical financial statements, if any, or that they are consistent with the purpose of the presentation.[12]

e. Presentation of the financial forecast follows the AICPA guidelines applicable for such statements.[13]

f. Assumptions have been adequately disclosed based upon AICPA presentation guidelines in section 400.

.33 The accountant should consider whether the financial forecast, including related disclosures, should be revised because of (a) mathematical errors, (b) unreasonable or internally inconsistent assumptions, (c) inappropriate or incomplete presentation, or (d) inadequate disclosure.

.34 The accountant should obtain written representations from the responsible party acknowledging its responsibility for both the presentation and the underlying assumptions. The representations should be signed by the responsible party at the highest level of authority who the accountant believes is responsible for and knowledgeable, directly or through others in the organization, about the matters covered by the representations.

.35 The representations should include a statement that the financial forecast presents, to the best of the responsible party's knowledge and belief, the expected financial position, results of operations, and changes in financial position for the forecast period and that the forecast reflects the responsible party's judgment, based on present circumstances, of the expected conditions and its expected course of action. If the forecast contains a range, the representation should also include a statement that, to the best of the responsible party's knowledge and belief, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

12. The accounting principles used in a financial projection need not be those expected to be used in the historical financial statements for the prospective period if use of different principles is consistent with the purpose of the presentation (for example, an entity that reports its inventory on a FIFO basis for its historical financial statements might present a projection using a LIFO inventory basis to analyze the effects of a change in inventory method).

13. Presentation guidelines for entities that issue financial forecasts are set forth in section 400.

.35P The representations should include a statement that the financial projection presents, to the best of the responsible party's knowledge and belief, the expected financial position, results of operations, and changes in financial position for the projection period, given the hypothetical assumptions, *and that the projection reflects its judgment, based on present circumstances, of expected conditions and its expected course of action given the occurrence of the hypothetical events. The representations should also (1) identify the hypothetical assumptions and describe the limitations on the usefulness of the presentation, (2) state that the assumptions are appropriate, (3) indicate if the hypothetical assumptions are improbable, and (4) if the projection contains a range, the representations should also include a statement that, to the best of the responsible party's knowledge and belief, given the hypothetical assumptions, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.*

Using the Work of a Specialist

.36 During his examination, the accountant may encounter matters that in his judgment require using the work of a specialist; for example, an engineer, economist, investment banker, or architect. Although the guidance provided in SAS No. 11, *Using the Work of a Specialist*, is intended for the auditor of historical financial statements, it is generally applicable when the accountant examining a financial forecast uses the work of a specialist.

Assumptions Dependent on the Actions of Users

.37 Occasionally, a forecast is predicated on a significant assumption that relates directly to a user's prospective action. For example, an assumption may relate to obtaining debt or equity when the forecast is to be used to solicit that debt or equity, or an assumption may relate to the passage of a referendum when the forecast is to be used by voters deciding on the referendum. In such a case the accountant may have difficulty in obtaining support for the assumption. If the assumption is subject to many possible outcomes, for example, if the entity would be willing to issue debt or equity in an amount less than that reflected in the forecast, the accountant would need to obtain support for the assumption to issue an unqualified examination report. If, on the other hand, the assumption is subject to only two possible outcomes (that is, an either/or situation), for example, if an entity will not issue the debt or equity unless it places the *entire* debt or equity reflected in the forecast, the accountant may issue an examination report without obtaining support for that assumption as long as the assumption is not unreasonable on its face. In such a case, users would not be expected to rely on the forecast once the prospective action does not take place and the assumption does not materialize. Accordingly, the accountant's report would be unaffected by the lack of support for the assumption provided that the forecast discloses the limitations on the usefulness of the presentation.[14] That is, the forecast should state that the responsible party believes that the forecast represents the entity's expected financial position, results of operations, and changes in financial position only if the prospective action of users takes place.

Working Papers

.38 The accountant's working papers in connection with his examination of a financial forecast should be appropriate to the circumstances and the accountant's needs on the engagement to which they apply. Although the quantity, type, and content of working papers vary with the circumstances, they ordinarily should indicate that—

a. The work was adequately planned and supervised.
b. The process by which the entity develops its financial forecast was considered in determining the scope of the examination.
c. Sufficient evidence was obtained to provide a reasonable basis for the accountant's report.

Illustrative Examination Procedures

.39 The following procedures are listed to assist the accountant in planning examinations of financial forecasts. The list is neither a complete summary of all possible procedures nor an outline of minimum procedures, but it should aid in the development and selection of procedures for a particular engagement. The accountant may

14. In such circumstances the representations the accountant receives from the responsible party may be modified to state that the forecast presents, to the best of the responsible party's knowledge and belief, expected financial position, results of operations, and changes in financial position, based on the assumed prospective action of the users.

be able to achieve the same objectives by procedures other than those illustrated.

.40 Although the responsible party may call upon the accountant to assist in identifying and formulating assumptions, as well as translating those assumptions into dollar estimates for inclusion in the financial forecast, the accountant is responsible to perform examination procedures to obtain appropriate support to afford a reasonable basis for his report.

.41 The procedures are divided into three categories:

a. Procedures to determine the scope of the examination
b. Procedures to evaluate assumptions
c. Procedures to evaluate the preparation and presentation of the financial forecast

.42 **Procedures to Determine the Scope of the Examination**

a. Obtain knowledge of the entity's business by —
   (i) Interviewing entity personnel and other individuals knowledgeable about the industry.
   (ii) Consulting AICPA guides, industry publications, textbooks, and periodicals.
   (iii) Analyzing financial statements of the entity and of other entities in the industry.

   The accountant may have previously obtained some or all of this knowledge through experience with the entity or its industry.

b. In obtaining knowledge of the entity's business, consider —
   (i) Resources needed by the company (availability and cost).
      - Material
      - Labor
      - Capital
      - Fixed assets (for example, capacity of plant and equipment)
   (ii) Markets served by the company (nature and condition).
      - Intermediate markets
      - Final consumer markets
      - Entity's market share
      - Advertising and marketing plans

(iii) Factors specific to the industry.
- Competitive conditions
- Sensitivity to economic conditions
- Accounting policies
- Specific regulatory requirements
- Technology

(iv) Patterns of past performance for the entity or comparable entities.
- Trends in revenue and costs
- Turnover of assets
- Uses and capabilities of physical facilities
- Management policies

c. Obtain or assemble the financial forecast together with a list of the significant assumptions and their descriptions.

d. Review the process used in preparing the financial forecast to obtain an understanding of the rationale by which key factors are identified and assumptions are developed and of the process by which assumptions are translated into prospective data. The accountant would look for answers to such questions as these:

(i) Is preparation of the financial forecast adequately documented to permit tracing through the process? The accountant may decide to prepare a brief outline of the process used to develop financial forecast.

(ii) Has the process been used in the past to generate financial forecasts, and, if so, was it effective?

(iii) What procedures provide reasonable assurance that all significant factors are included in the assumptions?

(iv) What procedures provide reasonable assurance that the financial forecast is based on assumptions approved by the responsible party?

(v) What are the methods for collecting, calculating, and aggregating prospective data?

(vi) What methods identify and quantify the impact of variations in assumptions?

(vii) What are the procedures to effect changes in accounting principles and reflect them in the financial forecast?

(viii) If the process used to develop financial forecasts has been in operation or used in the past, are there procedures to compare prior prospective amounts with the historical results for the same period and analyze the differences where applicable? (For example, differences in forecasted amounts and actual results should be analyzed to ascertain that identified causes are considered.) Are the procedures used to adjust the process, where applicable, as a result of such analysis?

(ix) What are the responsible party's review and approval procedures?

(x) How are errors prevented or detected?

e. Identify any models and techniques that are used. If possible, obtain a description of them.

f. Having reviewed the process by which the responsible party develops its financial forecasts, analyze its strengths and weaknesses by comparing it with the guidelines outlined in section 300.

g. Consider the competence of the entity's personnel involved in the process, including their degree of authority, prior experience with the entity and industry, and understanding of both the entity's plans and the process, in relation to their functions in the process and in entity operations.

h. Review documentation of both the financial forecasts and process to develop them or otherwise investigate whether there is —

(i) Review and approval by the responsible party.

(ii) Determination of the relative effect of variations in major underlying assumptions.

(iii) Use of appropriate accounting principles and practices.

i. Test significant elements of the process designed to prevent or detect errors, including clerical errors.

j. Where applicable, review the entity's documentation of the comparison of actual results with amounts contained in previous financial forecasts (if any) for that period and consider (a) whether the comparison was performed using correct, comparable data and whether analyzed differences were documented and appropriately supported, (b) whether the process was adjusted where appropriate, (c) whether the procedures to develop financial forecasts in the past have reflected the entity's plans properly, and (d) whether any consistent biases have been observed.

k. Based on the knowledge obtained in the foregoing procedures, design the examination procedures for evaluating the assumptions and the preparation and presentation of the financial forecast.

.43 **Procedures to Evaluate Assumptions**

a. Identify key factors upon which the financial results of the entity appear to depend.
   (i) Evaluate both the assumptions listed in the financial forecast and the more detailed data included in the underlying documentation to determine the completeness of the list. Factors to consider include —
   - Risks inherent in the business.
   - Sensitivity to variations.
   - Pervasiveness of the impact of particular factors on the various assumptions.

   (ii) Obtain financial forecasts of similar entities, if available, and consider whether the key factors covered by the assumptions therein are covered in the client's statements.
   (iii) Analyze prior-period financial results to help identify the principal factors that influenced the results. If any interim historical results are available, consider any significant deviations from historical patterns and investigate the causes.
   (iv) Review any public statements, formal plans, and the minutes of board of directors' meetings, noting any significant decisions regarding plans, contracts, or legal agreements.
   (v) Question the responsible party regarding possible additional factors or changes in assumptions about factors.
   (vi) Using the knowledge of the entity and its industry, investigate any particularly risky or sensitive aspect of the business — market trends, competitive conditions, pending laws and regulations, social, economic, political and technological influences, and dependence upon major customers and suppliers.

b. Evaluate whether the assumptions are suitably supported.
   (i) Evaluate the support for the assumptions, giving special attention to specific assumptions that are—

- Material to the prospective amounts.
- Especially sensitive to variations.
- Deviations from historical patterns.
- Especially uncertain.

(ii) For key assumptions, obtain a list of internal and external sources of information that the entity used in formulating the assumptions. On a test basis, evaluate whether the information was considered in formulating the assumptions.

(iii) Trace assumptions about selected key factors to the support for the assumptions to determine whether the indicated sources of information were actually used and evaluate the suitability of existing support. If the information is taken from internal analyses, consider the need for testing the supporting information.

(iv) Review any available documentation of the responsible party's plans, such as budgets, spending estimates, policy statements, contractual agreements, among others, and inquire about those plans, goals, and objectives and consider their relationship to the assumptions.

(v) Investigate alternative sources of support for the assumptions and evaluate whether the preponderance of available information supports each significant assumption.[15]

(vi) Inquire about and analyze the historical data used in developing prospective amounts to assess—
- Whether it is comparable and consistent with the forecast period.
- Whether it is sufficiently reliable for the purpose.

(vii) If historical financial statements have been prepared for an expired part of the prospective period, read the historical data and consider them in relation to the prospective results for the same period.

(viii) If the financial forecast is based on the historical financial results for part of the forecast period and that part is significant to the presentation, make a review of the histori-

15. The cost to acquire the additional information should be commensurate with anticipated benefits. See section 313.02.

cal information in conformity with applicable standards for a review.

(ix) Consider alternative approaches to the development of the assumptions. For example, if the sales assumption was developed by aggregating individual salesmen's estimates, consider comparing the assumptions to historical patterns. Also consider trying other models and techniques.

(x) Evaluate whether the presentation extends to time periods for which suitable support for assumptions is not available, considering—
- The nature of the entity's industry.
- Patterns of past performance for the entity or comparable entities.

(xi) Where appropriate, consider confirming with external sources information supporting the assumptions. (For example, if the backlog of sales orders is significant to the financial forecast and is not adequately supported, consider sending written confirmation requests to customers.)

(xii) If the support for key assumptions comes from experts, such as lawyers, engineers, economists, investment bankers, and architects—
- Consider their professional standing.
- Consider using the work of another expert in the field.
- Review the data and plans the entity submitted to the expert for consistency with the financial forecast and supporting data.

(xiii) If the assumptions about the tax treatment of prospective transactions are sensitive, obtain support for their appropriateness by (a) analyzing prospective transactions in the context of applicable tax laws or (b) obtaining an opinion as to such matters from the entity's tax counsel or another accountant and applying the procedures in SAS No. 11, paragraphs 5 through 8.

(xiv) Obtain a representation letter from the responsible party.

(xv) Consider obtaining a letter from the client's legal counsel, as of the report date, covering—

- Litigation, claims and assessments.
- Legality of any major changes planned (such as marketing considerations, environmental impact, or patents) and other matters (such as the impact of new laws affecting the industry).

.43(b)P For a financial projection, the procedures shown in 700.43(b) would be applicable only to assumptions other than hypothetical assumptions. In addition the accountant should determine if the hypothetical assumptions are consistent with the purpose of the presentation.

.44 Procedures to Evaluate the Preparation and Presentation of the Financial Forecast

a. Test the mathematical accuracy of, or perform, the computations made in translating the assumptions into prospective amounts.

b. Evaluate whether data have been appropriately aggregated by—
   (i) Evaluating the appropriateness of mathematical equations, statistical techniques, or modeling procedures.
   (ii) Recomputing on a test basis.
   (iii) Tracing aggregate amounts to the financial forecast.

c. Determine whether the listed assumptions are those used in preparing the financial forecast.

d. Determine whether the effects of each assumption on all of the related prospective amounts have been reflected in the presentation.

e. Determine whether any assumption contradicts or is inconsistent with another.

f. Review the relationship between financial and other relevant data using appropriate mathematical or judgmental methods.

g. Review adjustments made in the data, considering whether they are justified and reasonable in relation to other information and whether their impact has been properly reflected in the financial forecast.

h. If historical data for part of the forecast period are included in the financial forecast, trace the amounts from the books, records, and other indicated sources to the financial forecast.

i. Determine whether the presentation is in conformity with the presentation guidelines in section 400, considering the following:
   (i) Is the financial forecast presented in the format of the historical financial statements expected to be issued? If not, are the required items presented?
   (ii) Are the accounting principles used—
   - Consistent with those used in the historical financial statements, if any?
   - Consistent with those expected to be used in future financial statements (including expected changes in accounting principles)?
   - Generally accepted accounting principles or based on another comprehensive basis of accounting?

   (iii) Is the basis of accounting used—
   - Consistent with that used in historical financial statements, if any?
   - Reconciled with the historical methods where different, or are the differences described?

   (iv) Are the assumptions adequately disclosed?
   (v) Are particularly sensitive assumptions identified?
   (vi) If the impact of a variation in an assumption is disclosed, is it appropriately stated?
   (vii) Is the financial forecast appropriately distinguished from historical financial statements?

.44P For a financial projection, the procedures in section 700.44 should be supplemented by the following considerations:

a. Are the purpose and limitations on the usefulness of the presentation disclosed?

b. Are accounting principles used consistent with the purpose of the presentation?

c. Is there an excessive number of hypothetical assumptions?

d. Are hypothetical assumptions identified?

Section 710

Illustrative Engagement and Representation Letters for an Examination

Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. *Italicized* paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term "forecast."

Engagement Letter

.01 The following is an excerpt from a sample engagement letter for an examination of a financial forecast:[1]

> This letter sets forth our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.
>
> We will examine, in accordance with standards established by the American Institute of Certified Public Accountants, from information management[2] provides, the forecasted balance sheet and related statements of income and retained earnings, changes in financial position and summaries of significant assumptions and accounting policies of XYZ Company as of December 31, 19XX, and the year then ending. We will examine the financial forecast for the purpose of issuing a report stating whether, in our opinion, (a) management's financial forecast is presented in conformity with applicable guidelines established by the American Institute of Certified Public Accountants and (b) management's assumptions provide a reasonable basis for its forecast.

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1. If the assumptions regarding income taxes are sensitive, for example, in a tax shelter offering, the accountant may wish his engagement letter to provide that the client will obtain a "tax opinion" from its counsel or that the accountant will undertake to apply those procedures necessary to satisfy himself about the tax assumptions.

2. If the responsible party is other than management, the references to management should be replaced with the name of the party who assumes responsibility for the assumptions.

Our examination of the financial forecast will include procedures we consider necessary to evaluate (a) the assumptions used by management as a basis for the financial forecast, (b) the preparation of the financial forecast, and (c) the presentation of the financial forecast.

Our report will detail the nature of reservations (if any) we have with respect to the forecast. Should any such reservations develop, we will discuss them with you before the report is issued.

A financial forecast presents, to the best of management's knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the forecast period. It is based on management's assumptions reflecting conditions it expects to exist and the course of action it expects to take during the forecast period.

Management is responsible for representations about its plans and expectations and for disclosure of significant information that might affect the ultimate realization of the forecasted results.

There will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. Our report will contain a statement to that effect.

We have no responsibility to update our report for events and circumstances occurring after the date of our report.

At the conclusion of the engagement, management agrees to supply us with a representation letter which, among other things, will confirm management's responsibility for the underlying assumptions and the appropriateness of the financial forecast and its presentation.

If management intends to reproduce and publish the forecast and our report thereon, they must be reproduced in their entirety, and both the first and subsequent corrected drafts of the document containing the forecast and any accompanying material must be submitted to us for approval.

.01P *The following is an excerpt from a sample engagement letter for an examination of a financial projection. The letter would be modified as appropriate.*[3]

This letter sets forth our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

3. If the assumptions regarding income taxes are sensitive, the accountant may wish his engagement letter to provide that the client will obtain a "tax opinion" from its counsel or that the accountant will undertake to apply those procedures necessary to satisfy himself about the tax assumptions.

We will examine, in accordance with standards established by the American Institute of Certified Public Accountants, from information management[4] *provides, the projected balance sheet and related statements of income and retained earnings, changes in financial position, and summaries of significant assumptions and accounting policies of XYZ Company as of December 31, 19XX, and the year then ending. We will examine the financial projection for the purpose of issuing a report stating whether, in our opinion, (a) management's financial projection is presented in conformity with applicable guidelines established by the American Institute of Certified Public Accountants and (b) management's assumptions provide a reasonable basis for its projection given the hypothetical assumptions.*

Our examination of the financial projection will include procedures we consider necessary to evaluate (a) the assumptions used by management as a basis for the financial projection, (b) the preparation of the financial projection, and (c) the presentation of the financial projection.

Our report will detail the nature of reservations (if any) we have with respect to the projection. Should any such reservations develop, we will discuss them with you before the report is issued.

The financial projection presents, to the best of management's knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the projection period assuming [describe hypothetical assumptions]. *It is based on management's assumptions reflecting conditions it expects would exist and courses of action it expects would be taken, assuming* [describe hypothetical assumptions].

Management is responsible for representations about its plans and expectations and for disclosure of significant information that might affect the ultimate realization of the projected results.

Even if [state hypothetical assumptions] *were to occur, there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and the differences may be material. Our report will contain a statement to that effect.*

We have no responsibility to update our report for events and circumstances occurring after the date of our report.

At the conclusion of the engagement, management agrees to supply us

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4. If the responsible party is other than management, the references to management should be replaced with the name of the party who assumes responsibility for the assumptions.

with a representation letter which, among other things, will confirm management's responsibility for the underlying assumptions and the appropriateness of the financial projection and its presentation.

We understand that the projection and our report thereon will be used only for [state intended limited use]. *If management intends to reproduce the projection and our report thereon, they must be reproduced in their entirety, and both the first and subsequent corrected drafts of the document containing the projection and any accompanying material must be submitted to us for approval.*

Representation Letter

.02 The following is a sample representation letter for an examination of a financial forecast. The written representations to be obtained should be based on the circumstances of the engagement.

[*Date of Accountant's report*]

[*Accountant's name*]

In connection with your examination of the forecasted balance sheet and related statements of income, retained earnings, and changes in financial position and summaries of significant assumptions and accounting policies of XYZ Company as of December 31, 19XX, and for the year then ending, we make the following representations:

1. The financial forecast presents our assumptions and, to the best of our knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the period[5] in conformity with the generally accepted accounting principles expected to be used by the Company during the forecast period, which are consistent with the principles that XYZ Company uses in preparing its historical financial statements.
2. The financial forecast is based on our judgment of the expected conditions and our expected course of action.
3. We have made available to you all significant information that we believe is relevant to the forecast.
4. We believe that the assumptions underlying the forecast are reasonable and appropriate.
5. To the best of our knowledge and belief, the documents and records supporting the assumptions are appropriate.

[*Signatures*]

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5. If the forecast is presented as a range, the description of the forecast would refer to the range (for example, ". . . at occupancy rates of 75 and 95 percent").

.02P The following is a sample representation letter for an examination of a financial projection. The written representations to be obtained should be based on the circumstances of the engagement.

[Date of Accountant's report]

[Accountant's name]

In connection with your examination of the projected balance sheet and related statements of income, retained earnings, and changes in financial position and summaries of significant assumptions assuming [describe hypothetical assumptions] *and accounting policies of XYZ Company as of December 31, 19XX, and for the year then ending, we make the following representations:*

1. *The financial projection presents our assumptions and, to the best of our knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the projection period assuming* [describe hypothetical assumptions].[6]
2. *The accounting principles used in the financial projection are in conformity with the generally accepted accounting principles expected to be used by the Company during the projection period, which are consistent with the principles that XYZ Company uses in preparing its historical financial statements.*[7]
3. *The financial projection is based on our judgment of the expected conditions and our expected course of action assuming* [describe hypothetical assumptions].
4. *We have made available to you all significant information that we believe is relevant to the financial projection.*
5. *We believe that the assumptions underlying the projection are appropriate and reasonable assuming* [describe hypothetical assumptions].
6. *To the best of our knowledge and belief, the documents and records supporting the assumptions are appropriate.*
7. *We intend to use this projection only for* [describe intended limited use].

[Signatures]

6. If the projection is presented as a range, the description of the projection would refer to the range (for example, ". . . at occupancy rates of 75 and 95 percent").

7. If the projection is not presented on the basis of the accounting principles used for the historical financial statements, this sentence might read "The accounting principles used in the financial projection are consistent with [*the special purpose for the projection*]."

.03 If the forecast is presented as a range, the following representation would be added:

> We reasonably expect that the actual [*describe items presented as a range*] achieved will be within the range shown; however, there can be no assurance that it will. The range shown was not selected in a biased or misleading manner.

> ***.03P*** *For a financial projection, if the presentation is presented as a range, the following representation would be added:*
>
> > *We reasonably expect that the actual* [describe items presented as a range] *achieved will be within the range shown assuming* [describe hypothetical assumption]; *however, there can be no assurance that it will. The range shown was not selected in a biased or misleading manner.*

.04 If the date of the signed representations is later than the date of the preparation of the forecast (see section 400.11), the following representation would be added:

> We are not aware of any material changes in the information or circumstances from [*date*], the date of the forecast, to the present.

Section 720

The Accountant's Examination Report

Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. *Italicized* paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term "forecast."

.01 The accountant's standard report on an examination of a financial forecast should include —

a. An identification of the financial forecast presented.

b. A statement that the examination of the financial forecast was made in accordance with AICPA standards and a brief description of the nature of such an examination.

c. The accountant's opinion that the financial forecast is presented in conformity with AICPA presentation guidelines[1] and that the underlying assumptions provide a reasonable basis for the forecast.

> ***.01(c)P*** *The accountant's opinion that the financial projection is presented in conformity with AICPA presentation guidelines*[2] *and that the underlying assumptions provide a reasonable basis for the projection* given the hypothetical assumptions.

d. A caveat that the forecasted results may not be achieved.

e. A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

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1. The accountant's report need not comment on the consistency of the application of accounting principles as long as the presentation of any change in accounting principles is in conformity with AICPA presentation guidelines as detailed in section 400.

2. The accountant's report need not comment on the consistency of the application of accounting principles as long as the presentation of any change in accounting principles is in conformity with AICPA presentation guidelines as detailed in section 400.

***.01P** In addition, the accountant's report on an examination of a financial projection should include a separate paragraph describing the limitations on the usefulness of the presentation.*

.02 The following is the form of the accountant's standard report on an examination of a forecast that does not contain a range.

> We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending.[3] Our examination was made in accordance with standards for an examination of a forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.
>
> In our opinion, the accompanying forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

***.02P** The following is the form of the accountant's standard report on an examination of a projection that does not contain a range.*

> *We have examined the accompanying projected balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending.[4] Our examination was made in accordance with standards for an examination of a projection established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the projection.*

3. When the presentation is summarized as discussed in section 400.06, this sentence might read "We have examined the accompanying summarized forecast of XYZ Company as of December 31, 19XX, and for the year then ending.

4. When the presentation is summarized as discussed in section 400.06, this sentence might read "We have examined the accompanying summarized projection of XYZ Company as of December 31, 19XX, and for the year then ending."

> *The accompanying projection and this report were prepared for* [state special purpose, for example, "the DEF National Bank for the purpose of negotiating a loan to expand XYZ Company's plant"] *and should not be used for any other purpose.*
>
> *In our opinion, the accompanying projection is presented in conformity with guidelines for presentation of a projection established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's projection* [describe the hypothetical assumption, for example, "assuming the granting of the requested loan for the purpose of expanding XYZ Company's plant as described in the summary of significant assumptions"]. *However, even if* [describe hypothetical assumption, for example, "the loan is granted and the plant is expanded"], *there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.*

.03 When the financial forecast contains a range, the accountant's standard report should also include a separate paragraph that states that the responsible party has elected to portray the expected results of one or more assumptions as a range. The following is an example of the separate paragraph to be added to the accountant's report when he examines a forecast that contains a range.

> As described in the summary of significant assumptions, management of XYZ Company has elected to portray forecasted [*describe financial statement element or elements for which the expected results of one or more assumptions fall within a range, and identify assumptions expected to fall within a range, for example, "revenue at the amounts of $X,XXX and $Y,YYY, which is predicated upon occupancy rates of XX percent and YY percent of available apartments"*] rather than as a single-point estimate. Accordingly, the accompanying forecast presents forecasted financial position, results of operations and changes in financial position [*describe one or more assumptions expected to fall within a range, for example, "at such occupancy rates"*]. However, there is no assurance that the actual results will fall within the range of [*describe one or more assumptions expected to fall within a range, for example, "occupancy rates"*] presented.

.04 The date of completion of the accountant's examination procedures should be used as the date of the report.

Modifications to the Accountant's Opinion

.05 The following circumstances result in the following types of modified accountant's report involving the accountant's opinion:

a. If, in the accountant's opinion, the prospective financial statements depart from AICPA presentation guidelines, he should issue a qualified opinion (see section 720.06) or an adverse opinion (see section 720.08).[5] However, if the presentation departs from the presentation guidelines because it fails to disclose assumptions that appear to be significant, the accountant should issue an adverse opinion (see sections 720.08 and .09).
b. If the accountant believes that one or more significant assumptions do not provide a reasonable basis for the forecast, he should issue an adverse opinion (see section 720.08).
c. If the accountant's examination is affected by conditions that preclude application of one or more procedures he considers necessary in the circumstances, he should disclaim an opinion and describe the scope limitation in his report (see section 720.10).

.05P *Because of the nature of financial projections, a hypothetical assumption is not intended to provide a reasonable basis for the presentation. Thus, the accountant's standard report on a financial projection would not be affected by the reasonableness of the hypothetical assumption. If one or more of the other significant assumptions do not provide a reasonable basis for the presentation given the hypothetical assumption, however, the accountant should give an adverse report. Section 720.08 illustrates the form of adverse report, which should be adapted for a financial projection.*

.06 *Qualified Opinion.* In a qualified opinion, the accountant should state, in a separate paragraph, all of his substantive reasons for modifying his opinion and describe the departure from AICPA presentation guidelines. His opinion should include the words "except" or "exception" as the qualifying language and should refer to the separate explanatory paragraph. The following is an example

5. However, the accountant may issue the standard examination report on a financial forecast filed with the SEC that meets the presentation requirements of article XI of Regulation S-X.

of an examination report on a forecast that is at variance with AICPA guidelines for presentation of a financial forecast.

> We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending. Our examination was made in accordance with standards for an examination of a forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.
>
> The forecast does not disclose reasons for the significant variation in the relationship between income tax expense and pretax accounting income as required by generally accepted accounting principles.
>
> In our opinion, except for the omission of the disclosure of the reasons for the significant variation in the relationship between income tax expense and pretax accounting income as discussed in the preceding paragraph, the accompanying forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.07 Because of the nature, sensitivity, and interrelationship of prospective information, a reader would find an accountant's report qualified for a measurement departure,[6] the reasonableness of the underlying assumptions, or a scope limitation difficult to interpret. Accordingly, the accountant should not express his opinion about these items with language such as "except for . . ." or "subject to the effects of. . . ." Rather, when a measurement departure, an unreasonable assumption, or a limitation on the scope of the accountant's examination has led him to conclude that he cannot issue an unqualified opinion, he should issue the appropriate type of modified opinion described in sections 720.08 through .14.

6. An example of a measurement departure is the failure to capitalize a capital lease in a forecast where the historical financial statements for the prospective period are expected to be presented in conformity with generally accepted accounting principles.

.08 *Adverse Opinion.* In an adverse opinion the accountant should state, in a separate paragraph, all of his substantive reasons for his adverse opinion. His opinion should state that the presentation is not in conformity with presentation guidelines and should refer to the explanatory paragraph. When applicable, his opinion paragraph should also state that, in the accountant's opinion, the assumptions do not provide a reasonable basis for the prospective financial statements. Set forth below is an example of an adverse opinion on an examination of a financial forecast which, in the accountant's opinion, contains a significant assumption that was unreasonable. The example should be revised as appropriate if the adverse opinion is issued, because the statements do not conform to the presentation guidelines.

> We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending. Our examination was made in accordance with standards for an examination of a financial forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.
>
> As discussed under the caption "Sales" in the summary of significant forecast assumptions, the forecasted sales include, among other things, revenue from the Company's federal defense contracts continuing at the current level. The Company's present federal defense contracts will expire in March, 19XX. No new contracts have been signed and no negotiations are under way for new federal defense contracts. Furthermore, the federal government has entered into contracts with another company to supply the items being manufactured under the Company's present contracts.
>
> In our opinion, the accompanying forecast is not presented in conformity with guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants because management's assumptions, as discussed in the preceding paragraph, do not provide a reasonable basis for management's forecast. We have no responsibility to update this report for events or circumstances occurring after the date of this report.

.09 If the presentation, including the summary of significant assumptions, fails to disclose assumptions that, at the time, appear to be significant, the accountant should describe the assumptions in his adverse report. The accountant should not examine a presentation that omits all disclosures of assumptions.

.09P In addition, the accountant should not examine a financial projection that omits (a) an identification of the hypothetical assumptions or (b) a description on the limitations of the usefulness of the presentation.

.10 *Disclaimer of Opinion.* The accountant can issue the standard report only if the examination has been conducted in accordance with AICPA standards and he has been able to apply all the procedures he considers necessary in the circumstances. The scope of the accountant's examination might be limited either (a) by client-imposed conditions that preclude the application of one or more procedures that the accountant considers necessary in the circumstances to comply with the standards or (b) by circumstances, such as the accountant's inability to evaluate one or more significant assumptions because they are not suitably supported. Limitations on the scope of the examination, whether imposed by the client or by other circumstances, may require the accountant to state in his report that he cannot evaluate the presentation of the financial forecast or assess whether the assumptions provide a reasonable basis for the presentation.

.11 If the accountant does not believe an assumption to be suitably supported, he should assess its effect on the interrelationships of assumptions and on the financial forecast taken as a whole.

.12 If the responsible party restricts the scope of the accountant's procedures or declines to develop the information the accountant considers necessary to evaluate one or more significant assumptions, the accountant generally should issue a report describing a scope limitation.

.13 In a disclaimer of opinion, the accountant's disclaimer should indicate, in a separate paragraph, the respects in which the examination did not comply with standards for an examination. The accountant should state that the scope of the examination was not sufficient to enable him to express an opinion with respect to the presentation or the underlying assumptions, and his disclaimer of opinion should include a direct reference to the explanatory paragraph. The following is an example of a report on an examination of a financial forecast for which a significant assumption could not be evaluated.

We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of

XYZ Company as of December 31, 19XX, and for the year then ending. Except as explained in the following paragraph, our examination was made in accordance with standards for an examination of a financial forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.

As discussed under the caption "Income From Investee" in the summary of significant forecast assumptions, the forecast includes income from an equity investee constituting 23 percent of forecasted net income, which is management's estimate of the Company's share of the investee's income to be accrued for 19XX. The investee has not prepared a forecast for the year ending December 31, 19XX, and we were therefore unable to obtain suitable support for this assumption.

Because, as described in the preceding paragraph, we are unable to evaluate management's assumption regarding income from an equity investee and other assumptions that depend thereon, we express no opinion with respect to the presentation of or the assumptions underlying the accompanying forecast. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.14 When there is a scope limitation and the accountant also believes there are material departures from the presentation guidelines, those departures should be described in the accountant's report.

Other Modifications to the Standard Examination Report

.15 The circumstances described below, although not necessarily resulting in modifications to the accountant's opinion, would result in the following types of modifications to the standard examination report.

.16 *Emphasis of a Matter.* In some circumstances, the accountant may wish to emphasize a matter regarding the financial forecast but nevertheless intends to issue an unqualified opinion. The accountant may present other information and comments he wishes to include, such as explanatory comments or other informative material, in a separate paragraph of his report.

.17 *Evaluation Based in Part on a Report of Another Accountant.* When more than one accountant is involved in the examination, the guidance provided for that situation in connection with examinations of historical financial statements is generally applicable (see

SAS No. 1, section 543). When the principal accountant decides to refer to the report of another accountant as a basis, in part, for his own opinion, he should disclose that fact in stating the scope of the examination and should refer to the report of the other accountant in expressing his opinion. Such reference indicates the division of responsibility for the performance of the examination.

.18 *Comparative Historical Financial Information.* Prospective financial statements may be included in a document that also contains historical financial statements and an accountant's report thereon[7]. In addition, the historical financial statements that appear in the document may be summarized and presented with the prospective financial statements for comparative purposes.[8] An example of the reference to the accountant's report on the historical financial statements when he examined, reviewed, or compiled those statements is presented in section 620.06.

.19 *Reporting When the Examination Is Part of a Larger Engagement.* When the accountant's examination of prospective financial statements is part of a larger engagement, for example, a financial feasibility study or business acquisition study, it is appropriate to expand the report on the examination of the prospective financial statements to describe the entire engagement.

.20 The following is a report that might be issued when an accountant chooses to expand his report on a financial feasibility study.[9]

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7. The accountant's responsibility with respect to those historical financial statements upon which he is not engaged to perform a professional service is described in SAS No. 26, *Association With Financial Statements,* in the case of public entities, and SSARS No. 1, *Compilation and Review of Financial Statements,* paragraphs 5 through 7, in the case of nonpublic entities.

8. SAS No. 42, *Reporting on Condensed Financial Statements and Selected Financial Data,* discusses the accountant's report for summarized financial statements derived from audited financial statements that are not included in the same document.

9. Although the entity referred to in the report is a hospital, the form of report is also applicable to other entities, such as hotels or stadiums. Also, although the illustrated report format and language should not be departed from in any significant way, the language used should be tailored to fit the circumstances that are unique to a particular engagement (for example, the description of the proposed capital improvement program, paragraph c; the proposed financing of the program, paragraphs b and d; the specific procedures applied by the accountant, paragraph e; and any explanatory comments included in emphasis-of-a-matter paragraphs, paragraph i, which deals with a general matter, and paragraph j, which deals with specific matters).

a. The Board of Directors
Example Hospital
Example, Texas

b. We have prepared a financial feasibility study of Example Hospital's plans to expand and renovate its facilities. The study was undertaken to evaluate the ability of Example Hospital (the Hospital) to meet the Hospital's operating expenses, working capital needs, and other financial requirements, including the debt service requirements associated with the proposed $25,000,000 [*legal title of bonds*] issue, at an assumed average annual interest rate of 10.0 percent during the five years ending December 31, 19X6.

c. The proposed capital improvements program (the Program) consists of a new two-level addition, which is to provide fifty additional medical-surgical beds, increasing the complement to 275 beds. In addition, various administrative and support service areas in the present facilities are to be remodeled. The Hospital administration anticipates that construction is to begin June 30, 19X2, and to be completed by December 31, 19X3.

d. The estimated total cost of the Program is approximately $30,000,000. It is assumed that the $25,000,000 of revenue bonds that the Example Hospital Finance Authority proposes to issue would be the primary source of funds for the Program. The responsibility for payment of debt service on the bonds is solely that of the Hospital. Other necessary funds to finance the Program are assumed to be provided from the Hospital's funds, from a local fund drive, and from interest earned on funds held by the bond trustee during the construction period.

e. Our procedures included analysis of—
   - Program history, objectives, timing, and financing.
   - The future demand for the Hospital's services, including consideration of—

     Economic and demographic characteristics of the Hospital's defined service area.

     Locations, capacities, and competitive information pertaining to other existing and planned area hospitals.

     Physician support for the Hospital and its programs.

Historical utilization levels.

- Planning agency applications and approvals.
- Construction and equipment costs, debt service requirements, and estimated financing costs.
- Staffing patterns and other operating considerations.
- Third-party reimbursement policy and history.
- Revenue/expense/volume relationships.

f. We also participated in gathering other information, assisted management in identifying and formulating its assumptions, and assembled the accompanying financial forecast based upon those assumptions.

g. The accompanying financial forecast for the annual periods ending December 31, 19X2, through 19X6, is based on assumptions that were provided by or reviewed with and approved by management. The financial forecast includes —

- Balance sheets.
- Statements of revenues and expenses.
- Statements of changes in financial position.
- Statements of changes in fund balance.

h. We have examined the financial forecast. Our examination was made in accordance with standards for an examination of a financial forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.

i. Legislation and regulations at all levels of government have affected and may continue to affect revenues and expenses of hospitals. The financial forecast is based on legislation and regulations currently in effect. If future legislation or regulations related to hospital operations are enacted, such legislation or regulations could have a material effect on future operations.

j. The interest rate, principal payments, Program costs, and other financing assumptions are described in the section entitled "Summary of Significant Forecast Assumptions and Rationale." If actual interest rates, principal payments, and funding requirements are different from those assumed, the amount of the bond issue and debt service requirements would need to be adjusted accordingly from those indicated in the forecast. If such interest rates, principal payments, and funding requirements are lower than those assumed, such adjustments would not adversely affect the forecast.

k. Our conclusions are presented below:
   - In our opinion, the accompanying financial forecast is presented in conformity with guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants.
   - In our opinion, the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.
   - The accompanying financial forecast indicates that sufficient funds could be generated to meet the Hospital's operating expenses, working capital needs, and other financial requirements, including the debt service requirements associated with the proposed $25,000,000 bond issue, during the forecast periods. However, the achievement of any financial forecast is dependent upon future events, the occurrence of which cannot be assured.

l. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Lack of Independence

.21 Whether or not the accountant is independent is something he must decide as a matter of professional judgment.[10] When the accountant is not independent, he cannot perform an examination in accordance with AICPA standards. In that case, the accountant may perform a compilation of the prospective financial statements and report accordingly.

10. In making a judgment about whether he is independent the accountant should be guided by the AICPA Code of Professional Ethics. Also see the auditing interpretation, "Applicability of Guidance on Reporting When Not Independent" (AICPA, *Professional Standards*, vol. 1, AU section 9504.19–.22).

Section 730

Considerations for the Accountant Reporting on an Examination of a Financial Forecast Contained in a Public Offering Statement

Because a public offering statement is a general use document, it would be inappropriate to include in it a projection unless the projection was used to supplement a forecast. Accordingly, the guidance in this section applies only to forecasts.

.01 This section discusses some aspects of the accountant's services with regard to financial forecasts when the forecast is included in a public offering statement. Public offering statements include registrations under the Securities Act of 1933 as well as certain non-SEC offerings such as private placement memorandums and tax-exempt bond offerings.[1]

Procedures Between the Date of the Accountant's Report and Effective Date in 1933 Act Filings

.02 A registration statement filed under the Securities Act of 1933 speaks as of its effective date, and the statutory responsibility of an accountant whose report is included in such a registration statement may be determined in the light of the circumstances as of such date. This aspect of an independent accountant's responsibility is peculiar to registration statements filed with the SEC.

.03 Unlike audited historical financial statements, financial forecasts, if prepared even a few weeks later, may well vary in some respects from earlier versions. Therefore, as provided in section 720, the report on an examination of a financial forecast should indicate that the accountant has no responsibility to update his report for events and circumstances occurring after the date of his report. Nevertheless, the accountant should have a reasonable basis to con-

1. These are categorized in section 210 as general uses of financial forecasts.

sent to the use of his report in a 1933 Act registration statement as of the consent[2] date.

.04 To have a reasonable basis to consent to the use of his report on the examination of a financial forecast in the registration statement, the accountant should perform procedures with respect to the period from the date of his examination report up to the consent date as close to the effective date as is reasonable and practicable in the circumstances. The accountant generally should —

a. Read the latest available interim financial statements, operating reports, and any relevant prospective information such as budgets; consider the prospective results in relation to the actual results achieved in the interim period; and inquire whether the accounting principles used in the preparation of such information are consistent with the principles used in preparing the forecast.

b. Read the entire prospectus and other pertinent portions of the registration statement and consider that information in relation to the prospective results and the summary of significant assumptions.

c. Inquire of and obtain written representations from the responsible party, including those individuals responsible for matters significant to the financial forecasts, as to whether there are any events, plans, or expectations (whether or not reflected or disclosed in the registration statement) that, in its opinion, may require the financial forecast to be modified, or that should be disclosed, in order that the forecast reflect the responsible party's judgment based on present circumstances of the expected conditions and its expected course of action. In lieu of obtaining an additional representation letter at the consent date, the accountant may have the responsible party update the representation letter originally signed at the report date.

2. Regulation S-K (section 229.10 (b)(1)) states that in the case of a registration statement under the 1933 Act a "reviewer (of a financial forecast) would be deemed an expert and an appropriate consent must be filed with the registration statement." (This regulation was issued before AICPA standards for services on prospective financial information, which define the three levels of service described in this guide. Thus, the SEC's terminology does not correspond to that used in this guide.)

d. Read the available minutes of meetings of the board of directors and related committees. Regarding meetings for which minutes are not available, inquire about matters dealt with at such meetings.

e. Make such additional inquiries or perform such procedures as he considers necessary and appropriate to dispose of questions that arise in carrying out the foregoing procedures.

.05 If, as a result of the above procedures, the accountant believes that the forecast, including the summary of significant assumptions, should be revised, he should request his client to revise its forecast and, if engaged to do so, examine the revised forecast. If the client does not make appropriate revision to the forecast, the accountant should not consent to the use of his report in the registration statement.

The Accountant's Consent

.06 In registration statements filed with the SEC under the Securities Act of 1933, as in other types of offering materials, the accountant's consent to the use of his report and to references to him in the offering materials should be in writing. In addition, the accountant's consent for a 1933 Act filing should be manually signed and dated.

.07 Because a registration statement under the 1933 Act speaks as of its effective date, the accountant's consent should be dated at or near the effective date of such a registration statement. The dating of the consent at the effective date, however, as discussed in section 730.03, does not constitute an update of the accountant's report.

.08 The following is an example of the accountant's consent to the use of his report in an offering statement.[3]

> We hereby consent to the use of our report dated November 17, 19X3, on our examination of the financial forecast of XYZ Company and the use of our name, and the references to our firm appearing under the headings [*appropriate headings*] in the registration statement. It should be noted that, as indicated in our report, we have no responsibility, under the standards for an examination of a financial forecast established by the American Institute of Certified Public Accountants, to update our report

3. This report consent example can also be used for non-SEC offerings.

for events and circumstances occurring after the date of the report, and consequently we have not updated our report.

Experts Section of 1933 Act Filings

.09 The experts section of the registration statement should be so worded that there is no implication that the forecast has been prepared by the accountant or that the forecast is not the direct responsibility of the responsible party. The following is an example of a reference to the accountant in the experts section.[4]

> The financial forecast on pages xx–yy of this prospectus has been examined by [*name of accountant*], independent public accountants, and is included herein in reliance on the authority of that firm as experts in reporting on examinations of financial forecasts.

Description of Additional Procedures and Comfort Letters

.10 No description of the additional procedures (see section 730.04) or any form of assurance based on those procedures should be included in the report on the forecast or in any document that includes the report. Further, no such description or assurance should be contained in a letter to underwriters ("comfort letter") or others.

4. The designation of the accountant as an "expert" is a concept that appears in section 11 of the 1933 Act. Therefore, the term as defined is generally applicable only to filings under the 1933 Act and not applicable to filings not made under that act.

Section 800

Application of Agreed-Upon Procedures

Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. The paragraphs in this section are applicable to both forecasts and projections, even though they use only the term "forecast."

.01 An accountant may accept an engagement to apply agreed-upon procedures to a financial forecast provided that (a) the specified users involved have participated in establishing the nature and scope of the engagement and take responsibility for the adequacy of the procedures to be performed, (b) distribution of the report is to be restricted to the specified users involved, and (c) the financial forecast includes a summary of significant assumptions.

.02 The accountant who accepts an engagement to apply agreed-upon procedures to a financial forecast should be independent; have adequate technical training and proficiency to apply agreed-upon procedures to a financial forecast; adequately plan the engagement and supervise the work of assistants, if any; and obtain sufficient evidence to provide a reasonable basis for his report on the results of applying the agreed-upon procedures.

.03 The accountant's procedures generally may be as limited or extensive as the specified users desire as long as the specified users take responsibility for their adequacy. However, mere reading of the financial forecast does not constitute a procedure sufficient to permit an accountant to report on the results of applying agreed-upon procedures to it.

.04 To satisfy the requirement that the specified users involved participate in establishing the nature and scope of the engagement and take responsibility for the adequacy of the procedures to be performed, the accountant ordinarily should meet with the specified users involved to discuss the procedures to be followed. This discussion may include describing, to the specified users, procedures that are frequently followed in similar types of engagements. Sometimes the accountant may not be able to discuss the procedures directly with all of the specified users who will receive the report. In such circumstances, the accountant may satisfy the requirement that the specified users involved take responsibility for the adequacy of the procedures by applying any one of the following or similar procedures:

a. Discussing the procedures to be applied with legal counsel or other appropriate designated representatives of the users involved, such as a trustee, a receiver, or a creditor's committee.
b. Reviewing relevant correspondence from the specified users.
c. Comparing the procedures to be applied to written requirements of a supervisory agency.
d. Distributing a draft of the report or a copy of the client's engagement letter to the specified users involved with a request for their comments before the report is issued.

Working Papers

.05 Although it is not possible to specify the form or content of the working papers that an accountant should prepare in connection with an engagement to apply agreed-upon procedures to a financial forecast, because of the different circumstances of individual engagements, the accountant's working papers ordinarily should indicate that—

a. The work was adequately planned and supervised.
b. The agreed-upon procedures were performed as a basis for the report.

Section 810

Illustrative Engagement and Representation Letters for Engagements to Apply Agreed-Upon Procedures

Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. *Italicized* paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term "forecast."

Engagement Letter

.01 The following is an excerpt from a sample engagement letter for an engagement to apply agreed-upon procedures to a financial forecast.

> This letter sets forth our understanding for applying agreed-upon procedures to the financial forecast of XYZ Company as of December 31, 19XX, and the year then ending.
>
> A financial forecast presents, to the best of management's[1] knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the forecast period. It is based on management's assumptions reflecting conditions it expects to exist and the course of action it expects to take during the forecast period.
>
> Management is responsible for representations about its plans and expectations and for disclosure of significant information that might affect the ultimate realization of the forecasted results.
>
> We will apply the following procedures, which [*state name of user*] has specified.[2] [*List procedures to be applied*]

---

1. If the responsible party is other than management, the references to management should be replaced with the name of the party who assumes responsibility for the assumptions.

2. If, at the time the engagement letter is prepared, the specified user has not established the necessary procedures, this paragraph might be replaced with (1) a list of procedures suggested by the accountant or those often done in the circumstances and (2) a statement that the engagement will not be completed until the user agrees that the procedures are sufficient for his purposes.

We make no representation as to the adequacy of these procedures for [*state name of user*]'s purposes.

There will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. Our report will contain a statement to that effect.

Our report will detail our findings. Should we have any reservations with respect to the forecast, we will discuss them with you before the report is issued.

We have no responsibility to update our report for events and circumstances occurring after the date of our report.

The distribution of our report is to be limited to [*name specified user*].

At the conclusion of the engagement, management agrees to supply us with a representation letter which, among other things, will confirm management's responsibility for the underlying assumptions and the appropriateness of the financial forecast and its presentation.[3]

.01P *The following is an excerpt from a sample engagement letter for an engagement to apply agreed-upon procedures to a financial projection.*

This letter sets forth our understanding for applying agreed-upon procedures to the financial projection of XYZ Company as of December 31, 19XX, and the year then ending.

The financial projection presents, to the best of management's[4] knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the projection period assuming [describe hypothetical assumptions]. *It is based on management's assumptions reflecting conditions it expects would exist and the course of action it expects would be taken, assuming* [describe hypothetical assumptions].

Management is responsible for representations about its plans and expectations and for disclosure of significant information that might affect the ultimate realization of the projected results.

---

3. This paragraph would be included if the accountant chooses to obtain a representation letter.

4. If the responsible party is other than management, the references to management should be replaced with the name of the party who assumes responsibility for the assumptions.

We will apply the following procedures, which [state name of user] *has specified.*[5] [List of procedures to be applied]

We make no representation as to the adequacy of these procedures for [state name of user]*'s purpose.*

Even if [describe hypothetical assumptions] *were to occur, there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. Our report will contain a statement to that effect.*

Our report will detail our findings. Should we have any reservations with respect to the projection, we will discuss them with you before the report is issued.

We have no responsibility to update our report for events and circumstances occurring after the date of our report.

The distribution of our report is to be limited to [name specified user].

At the conclusion of the engagement, management agrees to supply us with a representation letter which, among other things, will confirm management's responsibility for the underlying assumptions and the appropriateness of the projection and its presentation.[6]

Representation Letter

.02 The following is a sample representation letter for an engagement to apply agreed-upon procedures to a financial forecast. The written representations to be obtained should be based on the circumstances of the engagement.

[*Date of Accountant's report*]

[*Accountant's name*]

In connection with your engagement to apply agreed-upon procedures to the forecasted balance sheet and related statements of income,

5. If, at the time the engagement letter is prepared, the specified user has not established the necessary procedures, this paragraph might be replaced with (1) a list of procedures suggested by the accountant or those often done in the circumstances and (2) a statement that the engagement will not be completed until the user agrees that the procedures are sufficient for his purposes.

6. This paragraph would be included if the accountant chooses to obtain a representation letter.

retained earnings, and changes in financial position and summaries of significant assumptions and accounting policies of XYZ Company as of December 31, 19XX, and for the year then ending, we make the following representations:

1. The financial forecast presents our assumptions and, to the best of our knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the period,[7] in conformity with the generally accepted accounting principles expected to be used by the Company during the forecast period, which are consistent with the principles that XYZ Company uses in preparing its historical financial statements.
2. The financial forecast is based on our judgment of the expected conditions and our expected course of action.
3. We have made available to you all significant information that we believe is relevant to the forecast.
4. We believe that the assumptions underlying the forecast are reasonable and appropriate.
5. To the best of our knowledge and belief, the documents and records supporting the assumptions are appropriate.
6. The distribution of your report will be limited to [*name specified user*], who has represented to us that the procedures you applied to the forecast are sufficient for their purposes.

[*Signatures*]

.02P *The following is a sample representation letter for an engagement to apply agreed-upon procedures to a financial projection. The written representations to be obtained should be based on the circumstances of the engagement.*

[Date of Accountant's report]

[Accountant's name]

In connection with your engagement to apply agreed-upon procedures to the projected balance sheet and related statements of income, retained earnings, and changes in financial position and summaries of significant assumptions assuming [describe hypothetical assumptions] *and accounting policies of XYZ Company as of December 31, 19XX, and for the year then ending, we make the following representations:*

7. If the forecast is presented as a range, the description of the forecast would refer to the range (for example, ". . . at occupancy rates of 75 and 95 percent").

1. *The financial projection presents our assumptions and, to the best of our knowledge and belief, the Company's expected financial position, results of operations, and changes in financial position for the projection period assuming* [describe hypothetical assumptions].[8]
2. *The accounting principles used in the financial projection are in conformity with the generally accepted accounting principles expected to be used by the Company during the projection period, which are consistent with the principles that XYZ Company uses in preparing its historical financial statements.*[9]
3. *The financial projection is based on our judgment of the expected conditions and our expected course of action assuming* [describe hypothetical assumptions].
4. *We have made available to you all significant information that we believe is relevant to the financial projection.*
5. *We believe that the assumptions underlying the projection are appropriate and reasonable assuming* [describe hypothetical assumptions].
6. *To the best of our knowledge and belief, the documents and records supporting the assumptions are appropriate.*
7. *The distribution of the projection and your report will be limited to* [name specified user] *who has represented to us that the procedures you applied to the projection are sufficient for their purposes.*

.03 If the forecast is presented as a range, the following representation would be added:

We reasonably expect that the actual [*describe items presented as a range*] achieved will be within the range shown; however, there can be no assurance that it will. The range shown was not selected in a biased or misleading manner.

.03P *For a financial projection, if the presentation is presented as a range, the following representation would be included:*

We reasonably expect that the actual [describe items presented as a range] *achieved will be within the range shown assuming* [describe

8. If the projection is presented as a range, the description of the projection would refer to the range (for example, ". . . at occupancy rates of 75 and 95 percent").

9. If the projection is not presented on the basis of the accounting principles used for the historical financial statements, this sentence might read "The accounting principles used in the financial projection are consistent with [*the special purpose of the projection*]."

hypothetical assumption]; *however, there can be no assurance that it will. The range shown was not selected in a biased or misleading manner.*

.04 If the date of the signed representations is later than the date of the preparation of the forecast (see section 400.11), the following representation would be added:

We are not aware of any material changes in the information or circumstances from [*date*], the date of the forecast, to the present.

Section 820

The Accountant's Report on the Application of Agreed-Upon Procedures

Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. *Italicized* paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term "forecast."

.01 The accountant's report on the results of applying agreed-upon procedures should —

a. Indicate the financial forecast covered by the accountant's report.

b. Indicate that the report is limited in use, intended solely for the specified users, and should not be used by others.

c. Enumerate the procedures performed and refer to conformity with the arrangements made with the specified users.

d. If the agreed-upon procedures are less than those performed in an examination, state that the work performed was less in scope than an examination of a financial forecast in accordance with AICPA standards and disclaim an opinion on whether the presentation of the financial forecast is in conformity with AICPA presentation guidelines and on whether the underlying assumptions provide a reasonable basis for the forecast.

   .01(d)P *For a financial projection, the accountant should disclaim an opinion as to whether the underlying assumptions provide a reasonable basis for the projection* given the hypothetical assumptions *(if the procedures were less than those performed in an examination).*

e. State the accountant's findings.

f. Include a caveat that the prospective results may not be achieved.

g. State that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

.02 Also, the accountant may wish to state in his report that he makes no representation about the sufficiency of the procedures for the specified users' purposes.

.03 When the accountant reports on the results of applying agreed-upon procedures he should not express any form of negative assurance on the financial forecast taken as a whole.

.04 The following two examples illustrate reports that might be issued when the engagement is limited to applying agreed-upon procedures to a financial forecast.

Sample Report 1

Board of Directors — XYZ Corporation
Board of Directors — ABC Company

At your request, we have performed certain agreed-upon procedures, as enumerated below, with respect to the forecasted balance sheet, statements of income, retained earnings, and changes in financial position of DEF Company, a subsidiary of ABC Company, as of December 31, 19XX, and for the year then ending. These procedures, which were specified by the Boards of Directors of XYZ Corporation and ABC Company, were performed solely to assist you in connection with the proposed sale of DEF Company to XYZ Corporation. It is understood that this report is solely for your information and should not be used by those who did not participate in determining the procedures.

a. With respect to forecasted rental income, we compared the assumptions about expected demand for rental of the housing units to demand for similar housing units at similar rental prices in the city area in which DEF Company's housing units are located.
b. We tested the forecast for mathematical accuracy.

Because the procedures described above do not constitute an examination of prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants, we do not express an opinion on whether the prospective financial statements are presented in conformity with AICPA presentation guidelines or on whether the underlying assumptions provide a reasonable basis for the presentation.

In connection with the procedures referred to above, no matters came to our attention that caused us to believe that rental income should be adjusted or that the forecast is mathematically inaccurate. Had we performed additional procedures or had we made an examination of the forecast in accordance with standards established by the American Institute of Certified Public Accountants, matters might have come to our attention that would have been reported to you. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Sample Report 2

ABC Trustee
XYZ Company

At your request, we performed the agreed-upon procedures enumerated below with respect to the forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending. These procedures, which were specified by ABC Trustee and XYZ Company, were performed solely to assist you, and this report is solely for your information and should not be used by those who did not participate in determining the procedures.

a. We assisted the management of XYZ Company in assembling the prospective financial statements.
b. We read the prospective financial statements for compliance in regard to format with the AICPA presentation guidelines for presentation of a forecast.
c. We tested the forecast for mathematical accuracy.

Because the procedures described above do not constitute an examination of prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants, we do not express an opinion on whether the prospective financial statements are presented in conformity with AICPA presentation guidelines or on whether the underlying assumptions provide a reasonable basis for the presentation.

In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the format of the forecast should be modified or that the forecast is mathematically inaccurate. Had we performed additional procedures or had we made an examination of the forecast in accordance with standards established by the American Institute of Certified Public Accountants, matters might have come to our attention that would have been reported to you. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Section 900

Suggested Guidance on the Accountant's Services and Reports on Prospective Financial Statements for Internal Use Only

Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. *Italicized* paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term "forecast."

.01 An accountant may be engaged to provide services on financial forecasts that are restricted to internal use in a variety of circumstances including, for example, giving advice and assistance to his client concerning the tax consequences of future actions or in deciding whether to buy or lease an asset. An accountant may perform a compilation, examination, or application of agreed-upon procedures in accordance with AICPA standards[1] on a financial forecast when the financial forecast and the accountant's report are restricted to internal use.[2] However, when the forecast is to be restricted to internal use, the accountant may provide any of a spectrum of services on it. The section suggests procedural and reporting guidance that an accountant might use in providing such services on a financial forecast for internal use only.

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1. See sections 600 through 620 for guidance on compilations, 700 through 720 for examinations, and 800 through 820 for application of agreed-upon procedures.

2. In deciding whether a potential use is "internal use," the accountant should consider the degree of consistency of interest between the responsible party and the user regarding the forecast. If their interests are substantially consistent (for example, both the responsible party and the user are employees of the entity about which the forecast is made), the use would be deemed internal use. On the other hand, where the interests of the responsible party and the user are potentially inconsistent (for example, the responsible party is a nonowner manager and the user is an absentee owner), the use would not be deemed internal use. In some cases, this determination will require the exercise of considerable professional judgment.

.02 In satisfying himself that the forecast will be restricted to internal use, the accountant may rely on either the written or oral representation of the responsible party, unless information comes to his attention that contradicts the responsible party's representation.

Procedures

.03 The accountant's procedures should be consistent with the nature of his engagement. Other sections of this guide provide useful guidance on the type of procedures an accountant would apply when the nature of the engagement is similar to either a compilation, examination, or application of agreed-upon procedures.

.04 When an accountant provides other services on a financial forecast that is restricted to internal use, he should establish an understanding with his client, preferably in writing, regarding the services to be performed and should specify in this understanding that the financial forecast and his report, if any, are not to be distributed to outside users.

Reporting

.05 The Statement on Standards for Accountants' Services on Prospective Financial Information does not require the accountant to report on his service on a financial forecast for internal use only.[3] Thus, the accountant may provide what is sometimes called a "plain-paper" service.

.06 The accountant should be aware of Interpretation 201-2 of the AICPA Code of Professional Ethics, which provides that, when an accountant's name is associated with the forecast, he should disclose the character of work he has done and the degree of responsibility he has taken.

.07 If the accountant decides to issue a report on his services with respect to a financial forecast for internal use only, the report's form and content are flexible.[4] However, the report preferably would —

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3. However, if the forecast is, or reasonably might be, expected to be used by a third party, see section 500.02.

4. The accountant should also consider the guidance in rule 201(e) of the AICPA Code of Professional Ethics and related interpretation on reporting on prospective financial statements (see section 1000.05).

a. Be addressed to the responsible party.
b. Identify the statements being reported on.
c. Describe the character of the work he performed and the degree of responsibility he is taking[5] with respect to the financial forecast, in a manner that does not appear to vouch for the achievability of the financial forecast.
d. Indicate the restrictions as to the distribution of the financial forecast and report.
e. Be dated as of the date of the completion of his procedures.

.07P *In addition to the elements listed above, the accountant's report on a financial projection for internal use only preferably would include a description of the limitations on the usefulness of the presentation.*

.08 In addition to the above, the accountant's report would, where applicable, preferably —

a. Indicate if the accountant is not independent with respect to an entity on whose financial forecast he is providing services. An accountant should not provide any assurance on a financial forecast of an entity with respect to which he is not independent.
b. Describe the omission of any disclosures that come to his attention, including the omission of an identification of which of the disclosed assumptions that are included in the summary of significant assumptions are particularly sensitive (see section 400.24).

.09 The following is an example report, for cases in which the accountant chooses to issue a report, when he has assembled a financial forecast for which distribution is limited to internal use:

To Mr. John Doe, President
XYZ Company

We have assembled, from information provided by management, the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position and summaries of significant

5. The accountant's assurance on the financial forecast should not be similar to that given for an examination unless he complies with the procedures for an examination as described in section 700.

assumptions and accounting policies of XYZ Company as of December 31, 19XX, and for the year then ending. (This financial forecast omits the summary of significant accounting policies and, as would be required under established guidelines for presentation of a forecast, does not indicate which of the disclosed assumptions included in the summary of significant assumptions are particularly sensitive.)[6] We have not compiled or examined the financial forecast and express no assurance of any kind on it. Further, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. In accordance with the terms of our engagement, this report and the accompanying forecast are restricted to internal use and may not be shown to any third party for any purpose.

February 14, 19XX

.09P *The following is a report example when an accountant has assembled a financial projection for which distribution is limited to internal use:*

To Mr. John Doe, President

XYZ Company

We have assembled, from information provided by management, the accompanying projected balance sheet, statements of income, retained earnings, and changes in financial position and summaries of significant assumptions and accounting policies of XYZ Company as of December 31, 19XX, and for the year then ending. (This financial projection omits the summary of significant accounting policies and, as would be required under established guidelines for presentation of a projection, does not indicate which of the disclosed assumptions included in the summary of significant assumptions are particularly sensitive.)[7] *The accompanying projection and this report were prepared for* [state special purpose, for example, "presentation to the Board of Directors of XYZ Company for its considerations as to whether to add a third operating shift"] *and should not be used for any other purpose. We have not compiled or examined the financial projection and express no assurance of any kind on it. Further, even if* [state hypothetical assumption, for example, "the third operating shift is added"] *there will usually be differences between the projected and actual results, because events and circumstances frequently do not*

6. This sentence would be included if applicable.

7. This sentence would be included if applicable.

occur as expected, and those differences may be material. In accordance with the terms of our engagement, this report and the accompanying projection are restricted to internal use and may not be shown to any third party for any purpose.

February 14, 19XX

Guidance Regarding Partial Presentations

Section 1000

Partial Presentations

.01 A partial presentation, as used in this guide, is a presentation that excludes one or more of the items required for prospective financial *statements* (see section 400.06). Examples of partial presentations are sales forecasts, projections that present operating income but not net income or significant changes in financial position, and forecasted tax returns that do not show significant changes in financial position.

.02 This section does not attempt to address in detail preparation and presentation of partial presentations and the accountant's services on, and reports on services provided with respect to, partial presentations, but provides some guidance regarding such presentations.

Presentation

.03 A partial presentation is an appropriate type of presentation in many "limited use" cases. For example, to analyze whether to lease or buy a piece of equipment or the income tax implications of a given election, it may be necessary only to assess the effect on one aspect of financial results rather than on the financial statements overall. However, partial presentations are not ordinarily appropriate for "general use." Accordingly, the presentation should include a description of the purpose and any limitations on the usefulness of the presentation.

Accountant's Involvement With Partial Presentations

.04 When an accountant provides services with respect to a partial presentation, he should consider whether a presentation omitting one or more items required for prospective financial statements will adequately present the information based on its special purpose.

.05 The accountant who provides services with respect to a partial presentation should consider the reporting guidance in rule 201(e) of the AICPA Code of Professional Ethics, which states—

> A member shall not permit his name to be used in conjunction with any

> forecast[1] of future transactions in a manner which may lead to the belief that the member vouches for the achievability of the forecast.

The accountant should also consider Interpretation 201-2 of the AICPA Code of Professional Ethics. The interpretation, which applies to partial presentations, discusses the disclosure of assumptions and the disclosure of the character of work done by the accountant and the degree of responsibility taken by the accountant.

1. The Ethics rule was issued before the current definitions of financial forecast (section 200.04) and financial projection (section 200.05) were developed.

APPENDIXES

Appendix A

SEC POLICY ON PROJECTIONS

REGULATION S-K

(Title 17, Code of Federal Regulations)

Part 229—Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975—Regulation S-K

Reg. § 229.10. (b) *Commission policy on projections.* The Commission encourages the use in documents specified in Rule 175 under the Securities Act (§ 230.175 of this chapter) and Rule 3b-6 under the Exchange Act (§ 240.3b-6 of this chapter) of management's projections of future economic performance that have a reasonable basis and are presented in an appropriate format. The guidelines set forth herein represent the Commission's views on important factors to be considered in formulating and disclosing such projections.

(1) *Basis for projections.* The Commission believes that management must have the option to present in Commission filings its good faith assessment of a registrant's future performance. Management, however, must have a reasonable basis for such an assessment. Although a history of operations or experience in projecting may be among the factors providing a basis for management's assessment, the Commission does not believe that a registrant always must have had such a history or experience in order to formulate projections with a reasonable basis. An outside review of management's projections may furnish additional support for having a reasonable basis for a projection. If management decides to include a report of such a review in a Commission filing, there also should be disclosure of the qualifications of the reviewer, the extent of the review, the relationship between the reviewer and the registrant, and other material factors concerning the process by which any outside review was sought or obtained. Moreover, in the case of a registration statement under the Securities Act, the reviewer would be deemed an expert and an appropriate consent must be filed with the registration statement.

(2) *Format for projections.* In determining the appropriate format for projections included in Commission filings, consideration must be given to, among other things, the financial items to be projected, the period to be covered, and the manner of presentation to be used. Although traditionally projections have been given for three financial items generally considered to be of primary importance to investors (revenues, net income (loss) and earnings (loss) per share), projection information need not necessarily be

limited to these three items. However, management should take care to assure that the choice of items projected is not susceptible of misleading inferences through selective projection of only favorable items. Revenues, net income (loss) and earnings (loss) per share usually are presented together in order to avoid any misleading inferences that may arise when the individual items reflect contradictory trends. There may be instances, however, when it is appropriate to present earnings (loss) from continuing operations, or income (loss) before extraordinary items in addition to or in lieu of net income (loss). It generally would be misleading to present sales or revenue projections without one of the foregoing measures of income. The period that appropriately may be covered by a projection depends to a large extent on the particular circumstances of the company involved. For certain companies in certain industries, a projection covering a two or three year period may be entirely reasonable. Other companies may not have a reasonable basis for projections beyond the current year. Accordingly, management should select the period most appropriate in the circumstances. In addition, management, in making a projection, should disclose what, in its opinion, is the most probable specific amount or the most reasonable range for each financial item projected based on the selected assumptions. Ranges, however, should not be so wide as to make the disclosures meaningless. Moreover, several projections based on varying assumptions may be judged by management to be more meaningful than a single number or range and would be permitted.

(3) *Investor understanding.* (i) When management chooses to include its projections in a Commission filing, the disclosures accompanying the projections should facilitate investor understanding of the basis for and limitations of projections. In this regard investors should be cautioned against attributing undue certainty to management's assessment, and the Commission believes that investors would be aided by a statement indicating management's intention regarding the furnishing of updated projections. The Commission also believes that investor understanding would be enhanced by disclosure of the assumptions which in management's opinion are most significant to the projections or are the key factors upon which the financial results of the enterprise depend and encourages disclosure of assumptions in a manner that will provide a framework for analysis of the projection.

(ii) Management also should consider whether disclosure of the accuracy or inaccuracy of previous projections would provide investors with important insights into the limitations of projections. In this regard, consideration should be given to presenting the projections in a format that will facilitate subsequent analysis of the reasons for differences between actual and forecast results. An important benefit may arise from the systematic analysis of variances between projected and actual results on a continuing basis, since such disclosure may highlight for investors the most significant risk and profit-sensitive areas in a business operation.

(iii) With respect to previously issued projections, registrants are reminded of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, regarding their financial condition. This responsibility may extend to situations where management knows or has reason to know that its previously disclosed projects no longer have a reasonable basis.

(iv) Since a registrant's ability to make projections with relative confidence may vary with all the facts and circumstances, the responsibility for determining whether to discontinue or to resume making projections is best left to management. However, the Commission encourages registrants not to discontinue or to resume projections in Commission filings without a reasonable basis.

Appendix B

SEC GUIDES FOR DISCLOSURE OF PROJECTIONS OF FUTURE ECONOMIC PERFORMANCE

SECURITIES ACT OF 1933
Release No. 5992/November 7, 1978

SECURITIES EXCHANGE ACT OF 1934
Release No. 15305/November 7, 1978

AGENCY: Securities and Exchange Commission.
ACTION: Publication of revised guides.

SUMMARY: The Commission is issuing a statement encouraging the disclosure of projections and has authorized publication of Guides 62 and 5 of the Guides for Preparation and Filing of Registration Statements under the Securities Act of 1933 and of the Guides for the Preparation and Filing of Reports and Proxy and Registration Statements under the Securities Exchange Act of 1934, respectively. The Guides relate to the voluntary public disclosure by an issuer of projections of its future economic performance, both with respect to documents filed pursuant to the requirements of the federal securities laws and otherwise. The Guides set forth the Division of Corporation Finance's views regarding significant considerations to be taken into account in the disclosure of projections. In a related action, to further encourage the voluntary disclosure of projections by public companies the Commission is proposing for comment a rule to the effect that registrants generally would not be held liable under the federal securities laws for reasonably based projections made in good faith that are subsequently proven erroneous. See Release No. 33-5993 under Proposed Rules in this issue.

EFFECTIVE DATE: The Guides will be followed by the Commission upon publication in the *Federal Register*.

FOR FURTHER INFORMATION CONTACT: Steven J. Paggioli, Office of Disclosure Policy and Proceedings, Division of Corporation Finance, Securities and Exchange Commission, Washington, D.C. 202-376-8090.

SUPPLEMENTARY INFORMATION: The Commission has issued a statement indicating that it encourages certain issuers of securities to publish projected financial information in filings with the Commission or otherwise. The Commission also has authorized publication of Guides 62 and 5, "Disclosure of Projections of Future Economic Performance," of the Guides for the Preparation and Filing of Registration Statements under the Securities Act of 1933 [1] (the "Securities Act") (15 U.S.C. 77a et seq.) and the Guides for the Preparation and Filing of Reports and Proxy and Registration Statements under the Securities Exchange Act of 1934 (the "Exchange Act") (15 U.S.C. 78a et seq.). The Guides are not Commission rules nor do they bear the Commission's official approval; they represent practices followed by the Division of Corporation Finance in administering the disclosure requirements of the Securities Act and the Exchange Act.

In Securities Act Release No. 33-5699, April 23, 1976, 41 FR 19986, the Commission expressed its general views on the inclusion of projections in Commission filings and authorized the publication for public comment of then proposed Guides 62 and 4.[2]

Although the Guides were published for comment in Release 5699, the Commission indicated that the Division of Corporation Finance would follow the guides pending final action. The discussion which follows addresses certain issues raised in Release No. 33-5699 and the comments received thereon. However, attention is directed to the text of the Guides for a more complete understanding.

Background and Purpose

The issue of projections, economic forecasts, and other forward-looking information has been under active consideration by the Commission for several years.[3]

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1. Securities Act Release No. 4936, December 9, 1968 (33 FR 18617) as amended, 17 CFR 231.4936, as amended.

2. While proposed Guides 62 and 4 as announced in Release 33-5699 were pending, the Commission adopted new Guide 4, "Integrated Reports to Shareholders," on June 17, 1977, Securities Exchange Act Release 3639, 42 FR 31780 (June 23, 1977). Accordingly, the amended Guide under the Exchange Act is published today as Guide 5.

3. The Accounting Standards Division of the American Institute of Certified Public Accountants published a statement of position on "Presentation and Disclosure of Financial Forecasts" in August, 1975. The definitions of "financial forecast" and "financial projection" set forth there distinguish between a projection, which relates to "financial results based on assumptions which are not necessarily the most likely," and a forecast, which focuses on "the most probable financial position, results of operations and changes in financial position . . ." Although the semantic distinctions may become conformed over a period of time, the Commission emphasizes that in addressing the area of projections it envisions a concept which encompasses both forecasts and projections, as those terms were used by the AICPA. Thus, any statement by the issuer concerning future financial performance could be viewed as a projection subject to the guideline published herein, including those portions of the guide which require that the issuer have a reasonable basis for issuing such data; that the format and content of the projection not be susceptible of misleading inferences; and that the projection be presented in such a manner as will promote investor understanding.

Also, see Report of the Advisory Committee on Corporate Disclosure to the SEC

On November 1, 1972, the Commission announced a public rulemaking proceeding relating to the use, both in Commission filings and otherwise, of projections by issuers whose securities are publicly traded.[4] These hearings were ordered by the Commission for the purpose of gathering information relevant to a reassessment of its policies relating to disclosure of projected sales and earnings.

Information gathered at the hearings, held from November 10 to December 12, 1972, reinforced the Commission's observation that management's assessment of a company's future performance is of importance to investors, that such assessment should be comprehensible in light of the assumptions made and should be available, if at all, on an equitable basis to all investors. The hearings also revealed widespread dissatisfaction with the absence of guidelines or standards that issuers, financial analysts, or investors can rely on in issuing or interpreting projections.

On February 2, 1973, the Commission released a "Statement by the Commission on the Disclosure of Projections of Future Economic Performance." [5] In this statement, the Commission determined that on the basis of the information obtained through the hearings, staff recommendations, and its experience in administering the federal securities laws, changes in its long standing policy generally not to permit the inclusion of projections in registration statements and reports filed with the Commission would assist in the protection of investors and would be in the public interest. The Commission also set forth several conclusions regarding the manner in which projections should be made and announced that it had directed the Division of Corporation Finance to prepare specific releases and rule and form changes to implement the Commission's plan to integrate projections into the disclosure system.

On April 25, 1975 the Commission published a series of rule and form proposals relating to projections of future economic performance.[6] These proposals would have established an elaborate disclosure system for companies choosing to make public projections.

Approximately 420 letters of comment were received on these proposals. Although the majority of commentators agreed that projection

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(hereinafter "Report"), House Committee on Interstate and Foreign Commerce, 95th Cong., 1st Sess., Committee Print 95-29 (2 vols.), November 3, 1977, Appendix X-A for a general discussion of the development of the Commission's practices relating to projections, at A-265.

4. Securities Exchange Act Release No. 9844 (November 1, 1972) 37 FR 23850.

5. Securities Act Release No. 5362 (February 2, 1973) 38 FR 7220.

6. Securities Act Release No. 5581 (April 25, 1975) 40 FR 20316. These proposals also dealt with more timely reporting of changes in control of a registrant on Form 8-K. Amendments to the change in control disclosure requirement of Form 8-K were adopted in Securities Exchange Act Release No. 13156, January 13, 1977, 42 FR 4424.

information is significant, virtually all of them opposed the proposed system because they felt that the proposals would inhibit rather than foster projection communications between management and the investment community.[7] Due to the important legal, disclosure policy, and technical issues raised by the commentators, the Commission on April 23, 1976, determined to withdraw all but one of the proposed rule and form changes regarding projections.[8]

The Commission did, however, express its general views in the April 1976 release on the inclusion of projections in Commission filings, and authorized the publication for comment of proposed guides for the disclosure of projections in Securities Act registration statements and Exchange Act reports.

Release 33-5699 and the Proposed Guides

In its statement of general views in Release 33-5699, the Commission indicated that it would not object to disclosure in filings with the Commission of projections which are made in good faith and have a reasonable basis, provided that they are presented in an appropriate format and accompanied by information adequate for investors to make their own judgments. The Commission also expressed its concern over the problem of selective disclosure of material non-public information regarding registrants and reminded issuers of their responsibilities under the federal securities laws in connection with the dissemination of management's assessment of a company's future performance. The Commission noted that registrant's responsibilities to make full and prompt disclosure of material facts, both favorable and unfavorable, regarding their financial condition may extend to situations where management knows its previously disclosed assessments no longer have a reasonable basis.

Advisory Committee Recommendations

The Commission's disclosure policy on projections and other items of soft information was among the subjects considered by the Advisory Committee on Corporate Disclosure. In its final report, issued November 3, 1977, the Advisory Committee made several recommendations for significant changes in that policy.[9] Generally, the Committee

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7. See "Evaluation of SEC Policies and Practices Regarding Projections," in *Report supra* note 3, at A-265.

8. Securities Act Release No. 5699 (April 23, 1976) 41 FR 19986. The adopted amendment deleted the phrase "predictions as to specific future earnings" from the items of information described in note (c) to Rule 14a-9 under the Exchange Act (17 CFR 240.14a-9) as being possibly misleading.

9. *Report, supra* note 3, at 344-79.

recommended that the Commission issue a public statement encouraging companies voluntarily to disclose management projections in their filings with the Commission and elsewhere. In making this recommendation, the Advisory Committee noted that its position on specific aspects of projection disclosure would permit wide latitude to companies issuing projections and stated that the Commission should review and monitor projection disclosure to determine the utility to investors of such information and the costs to issuers.

The Commission's Views

The Commission concurs in the Advisory Committee's recommendation and findings. As noted by the Advisory Committee, the availability of forward-looking and analytical information is important to an investor's assessment of a corporation's future earning power and may be material to informed investment decision-making.[10] Projections and other types of forward-looking information are generally available within the investment community and are obtained and used by investors and their advisors.[11]

In addition, a majority of the commentators on the guides proposed in Release No. 5699 were in favor of a position that would permit the inclusion of projections in filings with the Commission by those issuers with the ability and willingness to make them.[12] Accordingly, in light of the significance attached to projection information and the prevalence of projections in the corporate and investment community, the Commission has determined to follow the recommendation of the Advisory Committee and wishes to encourage companies to disclose management projections both in their filings with the Commission and in general.[13] In order to further encourage such disclosure, the Commission has, in a separate release issued today, proposed for comment

10. *Report, supra* note 3, at 349-50.

11. The Advisory Committee's survey of individual investors indicated that nearly half of the investors surveyed favored disclosure in annual reports of a company's projected earnings per share for a full year. *Report* at 290. Similarly, the Advisory Committee staff survey of equity analysts indicated that management's projections of company performance are considered vital information in the first instance rather than simply confirmatory of analysts' own projections. *Report* at 55-57.

12. *See* comments collected in File No. S7-561.

13. The Advisory Committee also recommended that the Commission encourage the disclosure of other items of "soft information," such as planned capital expenditures and financing, management plans and objectives, statements of dividend policies, and statements of capital structure policies. See *Report* at 365-380. In this regard, guidelines for the disclosure of this information are being considered generally, as well as in connection with specific proposals to amend Guides 22 (Management Analysis of the Financial Statements) and 26 (Statement of Dividend Policy) to implement further the Advisory Committee's recommendations regarding soft information.

a safe-harbor rule for projection information whether or not included in Commission filings.[14] The Commission also has determined to authorize publication of revised staff guides to assist implementation of the Advisory Committee's recommendation. A summary of the recommendations of the Advisory Committee regarding particular aspects of projection disclosure, corresponding comments received on the guides as proposed in Release No. 5699 and in response to Release No. 5707,[15] and the position adopted in the final guides is set forth immediately below.

Discussion of the Staff's Guides Published Herein—Voluntary versus Mandatory Disclosure

In the proposed guides published in Release 33-5699, the Division of Corporation Finance set forth its view that management should have the option to present in Commission filings its good faith assessment of a company's future performance. The Advisory Committee and the commentators are in accord with the view that a voluntary projection system is more appropriate than a mandatory system. The Advisory Committee noted that a mandatory system would require the adoption of specific disclosure rules and regulations and felt that the Commission did not yet have an appropriate basis for formulating such requirements. In addition, the Committee did not believe that all companies should be required to sustain the expenses and burdens that might be associated with mandatory disclosure. Further, the Committee was of the view that many companies would find it difficult to prepare adequate projections due to lack of operating history, general economic factors, or industry conditions and should not be compelled to subject themselves to possible risks of liability for inaccurate projections.[16]

In view of the Advisory Committee's recommendation and the comments received, the proposed guides continue to reflect the position that disclosure of projections and other items of forward-looking information in Commission filings is permitted but not required.

However, the concern expressed in Release 33-5699 is reiterated regarding the selective disclosure of material non-public information; projection information should not be made available on a selective

14. Securities Act Release No. 5993. *See* Proposed Rules in this issue.

15. In Securities Act Release No. 5707, May 18, 1976, 41 FR 21370, comments were solicited by the Advisory Committee on the following question: "Should the SEC require corporate filings to set forth more forward-looking and analytical information regarding the company's business operations?" (Please consider the legal liability and competitive problems associated with such a requirement and whether such information should be reviewed by auditors.)

16. *Report, supra* note 3, at 354-55.

basis. Issuers have a further responsibility to make full and prompt disclosure of material facts regarding their financial condition, and this responsibility extends to situations where previously disclosed projections no longer have a reasonable basis.

Reporting Companies/Nonreporting Companies

The Commission's 1975 rule proposals included a three year Exchange Act reporting history and prior budgeting experience requirement in order to qualify for the safe harbor protection. Several commentators [17] took issue with this requirement, and suggested that projection information regarding new and promotional companies may be more significant in that forecast information may be most valuable regarding companies that do not have a history of public information.

Although the 1975 proposals were ultimately withdrawn, the guides proposed in Release 5699 indicated the Division's view that a history of operations or experience in projecting may be among the factors providing a reasonable basis for management's assessment of a company's future economic performance. Nevertheless, it would not appear that such history and experience would be necessary in all instances to provide reasonably based projections. Accordingly, the revised guides do not provide reporting, operating history, or other status criteria for those public companies desiring to make public projection disclosure.[18]

Disclosure of Assumptions

In paragraph (c) of the proposed guides the Division indicated its belief that investor understanding of the basis for and limitations of projections would be enhanced by disclosure of the assumptions which in management's opinion are significant to the projections or are the key factors upon which the financial results of the enterprise depend. The commentators generally were in accord with the position that disclosure of assumptions is perhaps the most significant factor in facilitating investor understanding. As noted by the Advisory Committee, such disclosure provides a framework for analysis of the projection and further reflects on management's planning capabilities. However, the Advisory Committee recommended that disclosure of assumptions be encouraged but not required, in order to make pro-

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17. Securities Act Release No. 5581, April 28, 1975, 40 FR 20316.

18. See *Report, supra* note 3, at 356. This result is consistent with the recommendations of the Advisory Committee.

jecting more attractive to registrants, until there is more experience with projection disclosure.[19]

While the Division believes that disclosure of assumptions would help investors to comprehend projections and assist in establishing a reasonable basis for projections disclosed, there may be instances where reasonably based and adequately presented projections would significantly add to the mix of information available to investors in the absence of disclosure of underlying assumptions. However, the Division believes under certain circumstances the disclosure of underlying assumptions may be material to an understanding of the projected results. For example, where projected results are based to a significant degree upon the introduction of a new product or service meeting certain anticipated levels of sales and contribution to earnings, disclosure of the projection without this information might be misleading.

Items to Be Projected

Paragraph (b) of the proposed guides indicated that traditionally projections have been given for three items generally considered to be of primary interest to investors: sales or revenues, net income, and earnings per share. These items usually are presented together in order to avoid any misleading inferences that may arise when individual items reflect contradictory trends. Although these three items usually are the key elements in an appropriate presentation of a projection, the Division recognizes that there may be circumstances when company management should be given flexibility in determining whether other or additional financial items should also be presented.[20]

Third Party Review

The proposed guides suggested that additional support for projections could be furnished through an outside review. If such a review were to be included, disclosure of the reviewer's qualifications, the

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19. *Report, supra* note 3, at 358. The revised guides do not reflect the position that projections disclosed without assumptions are *per se* misleading. However, *Cf. Beecher* v. *Able,* 374 F. Supp. 341 (S.D.N.Y., 1974) wherein it was held that ". . . any assumptions underlying the projection must be disclosed if their validity is sufficiently in doubt that a reasonably prudent investor, if he knew of the underlying assumptions, might be deterred from crediting the forecast. Disclosure of such underlying assumptions is necessary to make . . . [the forecast] . . . not misleading." 374 F. Supp. at 348. However, it should be noted that the *Beecher* court went on to indicate that "[A]ll projections will be based on numerous assumptions, some of which are so reasonable and so likely to be borne out by the facts that they may be left unstated. *Id.* at n. 6.

20. See *Report, supra* note 3, at 362. The revised guides do not require that any specific items be projected. However, selective projection of only favorable items may create misleading inferences.

relationship of the reviewer to the registrant, and the extent of the review would be required. A reviewer would be deemed an expert and an appropriate consent would be required to be filed with a registration statement under the Securities Act, if the reviewed projection and report were included therein.[21]

A few commentators opposed outside review *per se,* suggesting that outside review could lend a false aura of greater credibility to projecting information. It was further suggested that "shopping" for favorable reviews would be possible under the proposed guides and that only those persons who can clearly demonstrate independence from management should be permitted to review projections.

The Advisory Committee concurred with the position on outside review as set forth in the proposed guides without further comment or recommendation. The final guides do not change this position on outside review.

Although the Division shares the expressed concern regarding relationship of reviewers to companies that make projections, it believes that outside review should be permitted, provided appropriate disclosures are made about relationships between reviewers and registrants.[22] In this regard, a person should not be named as an outside reviewer if he actively assisted in the preparation of the projection.

Revision and Updating of Projections

In Release 33-5699, the Commission reminded issuers of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, regarding their financial condition, and that this responsibility may extend to situations where management knows its previously disclosed assessments no longer have a reasonable basis. In addition, the proposed Guides recommended that investors be informed of management's intentions with respect to furnishing updated projections. Although the Advisory Committee concluded that periodic updating of projection information should not be required, it recommended that this position again be noted.[23]

The Advisory Committee also recommended that public companies

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21. See Section 7 of the Securities Act of 1933. 15 U.S.C. 77g.

22. The guides, as published, call for disclosure of the qualifications of the reviewer, and the extent of the review in detail sufficient to indicate how the projection was analyzed and evaluated, and the basis for the conclusion reached. Disclosure is also required as to any other material factors concerning any aspect of the process by which any outside review was sought or obtained. Depending upon the facts, this provision might require disclosure of a registrant's unsuccessful efforts to obtain an outside review. Also, the Auditing Standards Division of the AICPA currently has standards for review of projections under consideration.

23. This recommendation is incorporated in the published guides.

be allowed to revise their projections while "in registration," and that current projections would be appropriately included in registration statements (updated as necessary) filed under the Securities Act.[24]

In Release 33-5180,[25] "Guidelines for the Release of Information by Issuers Whose Securities are in Registration," the Commission stated that issuers in registration should avoid the issuance of forecasts, projections, or predictions relating but not limited to revenues, income, or earnings per share. Although an issuer in registration should carefully consider all facts and circumstances in determining whether a projection could be deemed to constitute an offer in violation of Section 5 of the Act, to the extent the position expressed in Release 33-5180 would prevent issuers in registration from making projections or including them in their filings that position is superseded.

Time Period for Projections; Discontinuance and Resumption

The proposed guides did not suggest a specific time period that may be appropriately covered by a projection. Due to factors that vary among industries, companies disclosing projections should have the responsibility for selecting the most appropriate time period depending on all the facts and circumstances. The Advisory Committee concurred in the approach taken by the proposed guides and the final guides reflect this position.

The Advisory Committee was also of the opinion that the use of projections would be encouraged if companies were permitted to discontinue making projections. Changed business conditions may make sound projections possible in one year and impracticable in another. Accordingly, the final guides incorporate the Advisory Committee's recommendation, but indicate that companies should not discontinue or resume making projections in Commission filings without a reasonable basis for such action. In the view of the Division, if the registrant were to furnish projections only when they are favorable and not when they are unfavorable, this pattern of disclosure might be viewed as misleading.

Other Matters

Tax Shelters

In a footnote to the proposed guides in Release 33-5699,[26] it is stated that in view of the different considerations that apply to tax shelter

24. See *Report, supra* note 3, at 360-361.
25. Securities Act Release No. 5180, August 16, 1971, 36 FR 16506.
26. Securities Act Release No. 5699, *supra* note 7, at note 5.

investments, the guides would not apply to filings covering such securities. Meaningful projections for tax shelter investments may involve a much longer time period, with a correspondingly more limited accuracy and reliability; items to be projected other than those traditionally used, such as sales/revenues, net income, and earnings per share may be more relevant in considering these investments.

Accordingly, the guides as proposed and adopted have been formulated with regard to projections made outside the context of tax shelter investments. However, certain items may be capable of more accurate prediction in tax shelters (e.g., depreciation, amortization and debt service) and reasonably based and adequately presented projections of such items are not intended to be precluded.

Projections Required by Regulatory Authorities

Frequently issuers are required to submit projection information to other federal and state regulatory authorities. This information often is requested with respect to a lengthy time period, e.g., ten years or more. This information may often be publicly available and may consist of material the accuracy of which might be questionable, in view of the length of time covered, when considered from the viewpoint of investors. Accordingly, issuers have raised questions regarding their obligations under the federal securities laws with respect to this information.

While the submission of this type of information to federal or state regulatory authorities pursuant to their requirements under circumstances in which it would be publicly available would not in and of itself violate the federal securities laws or require issuers to make corresponding public projections in filings with the Commission or otherwise, issuers should consider their obligation to assure that material facts concerning its financial condition are promptly and fully disclosed and that the information submitted does not become misleading by virtue of subsequent events.[27]

Operation of the Guides

As indicated above, publication of the amended guides is intended to implement the position of the Commission and of the Advisory Committee that the making of projections be encouraged. Because of

27. In this regard, issuers may wish to consider the appropriateness of clearly distinguishing such information from any projections already made, or clearly indicating that the information should not be considered as a projection for any purpose other than consideration by the requesting authority. In this connection, issuers may also wish to consider the appropriateness of filing a report on Form 8-K, 17 CFR 249.308, under Item 5, in which the furnishing of this information could be disclosed and the purpose of its submission and nature of its use clarified.

the Commission's responsibility to protect investors and safeguard the public interest in connection with sales and purchases of securities, the encouragement of projection information is an experiment and the relaxation of the Commission's policy in this area will be monitored. Since the amended guides substantially have been the subject of public comment, the guides will be effective immediately upon publication in the *Federal Register*. However, since the Commission is also proposing for comment a safe-harbor rule for projection disclosure (See Securities Act Release No. 5993 in this separate part), comment is also invited on the operation of the Guides in conjunction with the proposed rule. Comments should refer to File No. S7-760 and should be submitted in triplicate to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549. All comments will be available for public inspection.

Accordingly, 17 CFR Chapter II is amended as follows:

1. Part 231 is amended by adding Guide 62, "Disclosure of Projections of Future Economic Performance," to the Guides for Preparation and Filing of Registration Statements under the Securities Act of 1933 to read as follows:

Text of the Guides

Guide 62—DISCLOSURE OF PROJECTIONS OF FUTURE ECONOMIC PERFORMANCE

Preliminary Note

In furtherance of the Commission's policy of encouraging projections, as set forth in Securities Act Release No. 33-5992, this guide sets forth the views of the Division of Corporation Finance on the voluntary disclosure of projections of future economic performance in registration statements filed under the Securities Act of 1933. The Division encourages the use in registration statements of management's projections of future economic performance that have a reasonable basis and are presented in an appropriate format. The guidelines set forth herein represent the Division's views on important factors to be considered in formulating such projections.

The guides are not rules of the Commission nor are they published as bearing the Commission's official approval; they represent practices followed by the Commission's Division of Corporation Finance in administering the disclosure requirements of the federal securities laws.

1. Basis for Projections

The Division believes that management should have the option to present in Commission filings its good faith assessment of a registrant's future performance. Management must, however, have a reasonable basis for such an assessment. Although a history of operations or experience in projecting may be among the factors providing a basis for management's assessment, the Division does not believe that a company always must have had such a history or experience in order to formulate projections with a reasonable basis.

An outside review of management's projections may furnish additional support for having a reasonable basis for a projection. If management decides to include a report of such a review in the registration statement, there should also be disclosure of the qualifications of the reviewer, the extent of the review, the relationship between the reviewer and the registrant and any other material factors concerning the process by which any outside review was sought or obtained. Moreover, the reviewer would be deemed an expert and an appropriate consent must be filed with the registration statement.

2. Format for Projections

In determining the appropriate format for projections included in Commission filings, consideration must be given to, among other things, the financial items to be projected, the period to be covered, and the manner of presentation to be used. Although traditionally projections have been given for three financial items generally considered to be of primary importance to investors (revenues, net income and earnings per share), projection information need not necessarily be limited to these three items. However, management should take care to assure that the choice of items projected is not susceptible of misleading inferences through selective projection of only favorable items.

Revenues, net income, and earnings per share usually are presented together in order to avoid any misleading inferences that may arise when the individual items reflect contradictory trends. There may be instances, however, when it is appropriate to present earnings from continuing operations, or income before extraordinary items in addition to or in lieu of net income. It generally would be misleading to present sales or revenue projections without one of the foregoing measures of income.

The period that may appropriately be covered by a projection depends to a large extent on the particular circumstances of the company involved. For certain companies in certain industries, a projection covering a two or three year period may be entirely reasonable. Other companies may not have a reasonable basis for projections beyond the current year. Accordingly, management should select the period most appropriate in the circumstances. In addition, management in making a projection should disclose what in its opinion is the most probable specific amount or the most reasonable range for each financial item projected based on the selected assumptions. Ranges should not, however, be so wide as to make the disclosures meaningless. Moreover, several projections based on varying assumptions may be judged by management to be more meaningful than a single number or range and would be permitted.

3. Investor Understanding

When management chooses to include its projections in a Commission filing, the disclosures accompanying the projections should facilitate investor understanding of the basis for and limitations of projections. In this regard investors should be cautioned against attributing undue certainty to management's assessment, and the Division believes that investors would be aided by a statement indicating management's intention regarding the furnishing of updated projections. The Division also believes that investor understanding would be enhanced by disclosure of the assumptions which in management's opinion are most significant to the projections or are the key factors upon which the financial results of the enterprise depend, and encourages disclosure of assumptions in a manner that will provide a framework for analysis of the projection.

Management should also consider whether disclosure of the accuracy or inaccuracy of previous projections would provide investors with important insights into the limitations of projections. In this regard, consideration should be given to presenting the projections in a format that will facilitate subsequent analysis of the reasons for differences between actual and forecast results. An important benefit may arise from the systematic analysis of variances between projected and actual results on a continuing basis, since such disclosure may highlight for investors the most significant risk and profit-sensitive areas in a business operation.

With respect to previously issued projections, registrants are reminded of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, regarding their financial condition. This responsibility may extend to situations where management knows or has reason to know that its previously disclosed projections no longer have a reasonable basis.

Since a company's ability to make projections with relative confidence may vary with all the facts and circumstances, the responsibility for determining whether to discontinue or resume making projections is best left to management. However, the Division encourages companies not to discontinue or resume projections in Commission filings without a reasonable basis.

2. Part 241 is amended by adding Guide 5, "Disclosure of Projections of Future Economic Performance," to the Guides for the Preparation and Filing of Reports and Proxy and Registration Statements under the Securities Exchange Act of 1934 to read as follows:

Guide 5–GUIDES FOR THE PREPARATION AND FILING OF REPORTS AND PROXY AND REGISTRATION STATEMENTS UNDER THE SECURITIES EXCHANGE ACT OF 1934

DISCLOSURE OF PROJECTIONS OF FUTURE ECONOMIC PERFORMANCE

[The guide is identical to Guide 62 except (1) the first sentence of the Preliminary Note refers to "registration statements, reports, and proxy statements filed under the Securities Exchange Act of 1934," and (2) the last sentence of the second paragraph under the caption "Basis for Projections" concerning the filing of a consent by the reviewer-expert would be omitted.]

Authorization of Publication for Guides

The Commission hereby authorizes publication of Guides 62 and 5, pursuant to the Securities Act of 1933, particularly sections 7 and 10 thereof, and the Securities Exchange Act of 1934, particularly sections 12, 13, 15(d) and 23(a).

(Secs. 7, 10, 48 Stat. 78, 81; secs. 12, 13, 15(d), 23(a), 48 Stat. 892, 894, 895, 901; sec. 205, 48 Stat. 906; sec. 203(a), 49 Stat. 704; secs. 1, 3, 8, 49 Stat. 1375, 1377, 1379; secs. 8, 202, 68 Stat. 685, 686; secs. 3, 4, 10, 78; secs. 1, 2, 28(c), 84 Stat. 1435, 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 10, 18, 89, Stat. 117, 118, 119, 155; 15 U.S.C. 77g, 77j, 78l, 78m, 78o(d), 78w(a).)

By the Commission.

George A. Fitzsimmons
Secretary

Appendix C

SEC SAFE HARBOR RULE FOR PROJECTIONS

SECURITIES ACT OF 1933
Release No. 6084/June 25, 1979

SECURITIES EXCHANGE ACT OF 1934
Release No. 15944/June 25, 1979

PUBLIC UTILITY HOLDING CO. ACT OF 1935
Release No. 21115/June 25, 1979

TRUST INDENTURE ACT OF 1939
Release No. 532/June 25, 1979

AGENCY: Securities and Exchange Commission.
ACTION: Final rules.

SUMMARY: The Commission is adopting a rule providing a safe harbor from applicable liability provisions of the federal securities laws for statements made in filings with the Commission or in annual reports to shareholders that contain or relate to projections. In general, statements containing or relating to (i) projections of certain financial items, (ii) management plans and objectives, (iii) future economic performance included in management's discussion and analysis of the summary of earnings and (iv) disclosed assumptions underlying or relating to these statements would be deemed not to be false or misleading under the federal securities laws unless they were prepared without a reasonable basis or disclosed other than in good faith. The rule is being adopted in order to further the Commission's goal of encouraging the disclosure of projections and forward looking information both in Commission filings and in general.

EFFECTIVE DATE: July 30, 1979.

FOR FURTHER INFORMATION CONTACT: John J. Heneghan, Office of the Chief Counsel, Division of Corporation Finance, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549 (202) 755-1240.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission today adopted a rule designed to provide a safe harbor from the applicable liability provisions of the federal securities laws for statements relating to or containing (1) projections of revenues, income (loss), earnings (loss) per share or other financial items, such as capital expenditures, dividends, or capital structure, (2) management plans and objectives for future company operations, and (3) future economic performance included in management's discussion and analysis of the summary of earnings or quarterly income statements.[1] The rule is based on the alternatives that were proposed in Securities Act Release No. 5993 (November 7, 1978) (43 FR 53251).[2] The rule is adopted in furtherance of the Commission's goal of encouraging the disclosure of projections and other items of forward-looking information.[3] In a related action, the Commission is withdrawing the reference in note (a) to Rule 14a-9 (17 CFR 240.14a-9) to prediction of dividends as a possible example of a false or misleading statement. This release contains a brief discussion of the background of the proposed rules, the view of the commentators, and the provisions of the rule as adopted.

Background and Purpose

In Securities Act Release No. 5699, the Commission published for comment proposed Guides for projection disclosure and stated its belief that reasonably based and adequately presented projections should not subject issuers to liability under the federal securities laws solely because the projected results did not materialize.[4] In this regard, the Commission noted that even the most carefully prepared and thoroughly documented projections may prove inaccurate. Several of the commentators responding to the release urged the adoption of a

1. Guides 22 and 1 under the Securities Act of 1933 (the "Act") (15 U.S.C. 77a et seq. as amended by Pub. L. No. 94-29, June 4, 1975) and the Securities Exchange Act of 1934 (the "Exchange Act") (15 U.S.C. 78a et seq. as amended by Pub. L. No. 94-29, June 4, 1975), state that the analysis of the summary of earnings required by certain registration statements and reports such as those filed on Forms S-1, S-7, 10, and 10-K should include a discussion of material facts, whether favorable or unfavorable, required to be disclosed or disclosed in the prospectus which, in the opinion of management, may make historical operations or earnings as reported in the summary of earnings not indicative of current or future operations or earnings. In addition, Instruction 5 to Part I of Form 10-Q (17 CFR 249.308a) calls for an analysis of the quarterly income statements included in that form. Instruction 6 to Form 10-Q states that management also may furnish any additional information related to the periods being reported on which, in its opinion, is significant to investors.

2. On the same day that the "safe harbor" rules were proposed, the Commission also published revised Guides 62 and 5, "Disclosure of Projections of Future Economic Performance," under the Act and the Exchange Act. Securities Act Release No. 5992 (November 7, 1978) (43 FR 53246). The Guides set forth the views of the Division of Corporation Finance regarding important factors to be considered in disclosing projections of future company economic performance in reports and other Commission filings.

3. See Securities Act Release No. 5992, November 7, 1978, 43 FR 53246.

4. Securities Act Release No. 5699, 41 FR 19986, April 23, 1976. The proposed guides were revised and adopted in Securities Act Release No. 5992, *supra.*

safe harbor rule for projections made by issuers and reviewed by third parties, stating that the absence of a safe harbor rule might discourage the dissemination of projections.

While the proposed Guides were pending, the Commission's Advisory Committee on Corporate Disclosure also considered the subject of disclosure of forward looking information. In its final report, the Advisory Committee concurred with the Commission's views, recommending, however, the adoption of a safe harbor rule in order to encourage voluntary projection disclosure. Accordingly, at the time revised staff guides were published in final form, the Commission proposed its own safe harbor rule for comment in Release 33-5993 while at the same time requesting comments on the Rule recommended by the Advisory Committee in its final report. Both rules as proposed would provide protection to statements, whether or not included in filings with the Commission.

The Commission's proposed rule provided that for purposes of applicable liability provisions of the federal securities laws [5] a statement containing a projection of revenues, income (loss), and earnings (loss) per share would be deemed not to be an untrue statement of a material fact, a statement false or misleading with respect to any material fact, an omission to state a material fact necessary to make a statement not misleading, or the employment of a manipulative, deceptive, or fraudulent device, contrivance, scheme, transaction, act, practice, course of business, or an artifice to defraud as those terms are used in the applicable statutory provisions or any rules thereunder if the statement (1) was prepared with a reasonable basis and (2) was disclosed in good faith. As proposed, the rule applied to projections made by issuers (other than registered investment companies): (1) with a class of securities registered pursuant to Section 12 of the Exchange Act, (2) the securities of which are exempt from that Act under Section 12(g)(2)(G) thereof or (3) which are subject to the reporting requirements of Section 15(d) of the Exchange Act. An additional eligibility standard of the proposed rule required the issuer to have filed all the material required to be filed under sections 13, 14, or 15(d) of the Exchange Act at the time the statement is made. The proposed rule also would have extended to statements made on behalf of the issuer at the issuer's request such as statements made by the third party reviewers.

The Advisory Committee's rule provided protection for a wider variety of forward looking information than was covered by the Commission's proposed rule. The Advisory Committee's rule would have

5. See secs. 11, 12 and 17 (15 U.S.C. 77k, 1, and g) of the Securities Act of 1933; secs. 10, 18, and 20 (15 U.S.C. 78j, r, and t) of the Securities Exchange Act of 1934; sec. 16 (15 U.S.C. 79p) of the Public Utility Holding Company Act of 1935; and sec. 323 (15 U.S.C. 77ssw) of the Trust Indenture Act of 1939.

applied to statements of management concerning future company economic performance or of management plans and objectives for future company operations. The Advisory Committee rule also was not conditioned on status as a reporting company or currency of filings. Most significantly, the Advisory Committee rule had a different burden of proof. The rule would have deemed a statement not to be false or misleading under the federal securities laws unless the statement was prepared without a reasonable basis or was disclosed other than in good faith. Thus the burden of proof would have been on the plaintiff to show lack of a reasonable basis and absence of good faith.

In proposing alternative formulations, the Commission requested comment as to which format would further the goal of encouraging projection disclosure in a manner consistent with investor protection. Over ninety detailed letters of comment were received and considered by the Commission.[6] The following portions of the release discuss the major differences between the alternative proposals, the views of the commentators, the Commission's responses, and the rule adopted today.

General

In general, the commentators supported the Commission's effort to implement the Advisory Committee's recommendation to encourage the disclosure of projections and forward-looking information. However, some commentators expressed concern that, despite the voluntary nature of the program, companies choosing not to make projections might face pressure to do so, as other companies begin to disclose forward looking information. In addition these commentators were concerned that undue reliance may be placed on projections by investors. Notwithstanding these concerns, there was widespread support for the adoption of a safe harbor rule. By and large, the commentators shared the Advisory Committee's view that a safe harbor provision is needed if the Commission's goal of encouraging the disclosure of projections is to be realized. Most commentators favored the adoption of a rule that would incorporate aspects of each alternative rule proposed, and the rule adopted today incorporates aspects of both alternative formulations. Specific portions of the final rule are discussed immediately below.

Burden of Proof

The Commission's proposed rule placed the burden of proof on the defendant to prove that a projection was prepared with a reasonable basis and was disclosed in good faith. The proposed rule reflected the Commission's concern as to the difficulties faced by plaintiffs since the facts are in the exclusive possession of the defendants.

6. See comments collected in file No. S7-760.

The Advisory Committee rule would place the burden of proof on the plaintiff, along the lines of the Commission's existing safe harbor rules for replacement cost information and oil and gas reserve disclosures under Regulation S-X.[7]

This aspect of the proposed rules drew the most comment. Virtually all of the commentators expressed support for the Advisory Committee's formulation that would place the burden of proof on the plaintiff to establish the absence of a reasonable basis and good faith. Most commentators were of the view that the Commission's proposed rule would deter companies from making projections, thereby negating the Commission's objective. These commentators also believed that the Commission's proposed rule would in all likelihood increase the institution of frivolous, nuisance litigation based solely on the failure of the results to match projections, with a resulting cost and time burden to be borne by registrants.

Many commentators also took issue with the premises of the Commission's proposed rule, i.e., the concern that the burden of proof for plaintiffs might be insurmountable. These commentators asserted that the burden on a prospective plaintiff is not onerous in light of the current liberal discovery procedures available in federal courts as well as the Commission's broad investigatory powers. They also pointed out that cases involving projection disclosure have shown that discovery procedures and availability of public information have afforded plaintiffs an adequate basis to prove their cases against defendants.[8] In the view of some commentators, the proposed rule was in fact narrower than existing law and would afford less protection than no rule at all.

In view of the Commission's overall goal of encouraging projection disclosure and in light of the factors cited by the commentators, the Commission has determined to adopt the standard recommended by the Advisory Committee. The Commission's initiatives in projection disclosure are experimental in nature and will be watched closely to assure that the new policies embodied therein, including the adoption of this rule, do not yield results inconsistent with investor protection.[9]

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7. 17 CFR 210.3-17(g) and 210.3-18(k)(6)(v) respectively.

8. See, e.g., *Marx* v. *Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974); *Beecher* v. *Able,* 374 F.Supp. 341 (S.D.N.Y., 1974); *Green* v. *Jonnop,* 358 F.Supp. 413 (D. Ore. 1973).

9. With respect to forward looking statements, the rule interprets various terms of the liability provisions of the federal securities laws to require a showing that a forward looking statement was prepared without a reasonable basis and disclosed other than in good faith. If a plaintiff seeking to establish liability on the basis of a forward looking statement can make such a showing, he and the defendant must still meet whatever standards are applicable in the circumstances of the particular claim and the relief sought. *See e.g.,* Sections 12, and 17 [15 U.S.C. 77l and g] of the Securities Act and Sections 10, 18 and 20 [15 U.S.C. 78j, r, and t] of the Exchange Act.

Retention of Good Faith Requirement

Both the Commission's and the Advisory Committee's proposed rules require that reasonably based projections be disclosed in good faith. Several commentators believed that no objective standard exists for determining whether the "good faith" portion of the requirement has been met and that the term was ambiguous at best. Some commentators did not see how a reasonably based projection could be prepared and disclosed other than in good faith, and suggested that if a projection were found to have been prepared and disclosed with a reasonable basis, good faith disclosure is implicit.

On balance, the Commission believes that in light of the experimental nature of its program to encourage projection disclosure and the possibility of undue reliance being placed on projections, the use of good faith standard in the rule is appropriate. The Commission also notes that there is ample precedent for the concept of good faith in other provisions of the federal securities laws.[10]

Nature of Information Protected by the Rule

The Commission's proposed rule related only to projections of revenues, income (loss), earnings (loss) per share or other financial items. The Advisory Committee's proposed rule refers generally to statements of "management projection[s] of future company economic performance" or of "management plans and objectives for future company operations," and corresponds with that Committee's recommendation that disclosure of other types of forward looking information beyond those items customarily projected also should be encouraged.

Most commentators favored protecting a broader category of forward looking items than included in the Commission's proposed rule. Several suggested that since the Guides state that projections need not be limited to the three items traditionally presented, the scope of the safe harbor rule should correspond with this position. The commentators also were unsure of whether the phrase "other financial items" as used in the Commission's proposed rule was intended to cover the items referred to by the Advisory Committee.

At the time the alternative rules were proposed, the Commission noted that guidelines for the disclosure of these additional categories of forward looking information were under general consideration, as well as in connection with possible amendments to guides 22 (Man-

10. For example, Section 20(a) of the Exchange Act (15 U.S.C. 78t(a)) imposes liability on control persons for violations of that Act by persons controlled, unless the controlling person acted in good faith and did not directly induce the act or acts constituting the violation. Sections 18(a) and 78bb(e)(1) respectively and Section 2(a)(41)(A) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(41)(A)) also incorporate the concept of good faith determination.

agement Analysis of the Financial Statements) and 26 (Statement of Dividend Policy), and that safe harbor provisions would be considered when further proposals relating to other categories of forward-looking information were published for comment. Although specific guidelines relating to additional types of forward looking information are still under consideration, the Commission has determined that the scope of the safe harbor rule can be expanded at this time to cover those types of information that the commentators and the Advisory Committee urged should be within the protection of the rule. Accordingly, the rule adopted today expands the items in the proposed rule to cover projections of other financial items such as capital expenditures and financing, dividends, and capital structure,[11] statements of management plans and objectives for future company operations, and future economic performance included in management's discussion and analysis of the summary of earnings or quarterly income statements.[12] The rule has been revised to refer specifically to these other items of forward looking information in light of the commentators' suggestions that the broader coverage of the Advisory Committee rule be made explicit.

Disclosure of Assumptions

In Release 33-5992, the Commission emphasized the significance of disclosure of the assumptions that underlie forward-looking statements. As indicated in that release and Guide 62, disclosure of assumptions is believed to be an important factor in facilitating investors' ability to comprehend and evaluate these statements.

While the Commission has determined to follow the Advisory Committee's recommendation that disclosure of assumptions not be mandated under all circumstances, it wishes to re-emphasize its position on the significance of assumption disclosure. Under certain circumstances the disclosure of underlying assumptions may be material to an understanding of the projected results. The Commission also believes that the key assumptions underlying a forward looking statement are of such significance that their disclosure may be necessary in order for such statements to meet the reasonable basis and good faith standards embodied in the rule. Because of the potential importance of assumptions to investor understanding and in order to encourage

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11. In this connection, the Commission today has published proposed staff guidelines for disclosure in registration statements and reports filed by electric and gas utility companies. Securities Act Release No. 6085, see Proposed Rules in this issue. These proposed guidelines expressly request disclosure of certain forward looking information which would be covered by the safe-harbor rule adopted today.

12. *See* note 1 supra.

their disclosure, the rule as adopted indicates specifically that disclosed assumptions also are within its scope.[13]

Persons Covered by the Rule

The Commission's proposed rule was intended to protect statements made "by or on behalf of" the issuer in order to include statements of an outside reviewer of management's projections. The Advisory Committee's rule applied to management statements and does not specifically apply to statements by third party reviewers or define "management."

Most of the commentators believed that reviewers should be afforded protection under the rule and many suggested that the text of the final rule should specifically refer to reviewers. Based on a review by the Commission of these comments and of the issues involved, the final rule refers to statements made by or on behalf of an issuer or by an outside reviewer retained by the issuer.[14]

Companies Eligible for Protection

As proposed, the rule would have applied only to statements made if at the time of such statement a class of the registrant's securities was registered under Section 12(b) or (g) of the Exchange Act (or exempt from registration under Section 12(g)(2)(G) thereof), or the issuer was subject to the reporting requirements of Section 15(d) of the Exchange Act. The proposed rule would not have been available to statements made with respect to investment companies registered under the Investment Company Act of 1940.[15] As noted above, the availability of the Advisory Committee rule was not conditioned on a particular company's reporting or other status.

The Commission proposed the rule in this fashion, stating that projections might best be evaluated in the context of financial and other information about the company that is likely to be available through

13. Assuming that a forward-looking statement is otherwise made with a reasonable basis and in good faith, the failure to disclose one or more assumptions should not result in any difference in the burden of coming forward. In most, if not all cases, assumptions are an integral part in the formulation of forward-looking information. Disclosure or nondisclosure does not alter this relationship. Consequently, the language in the rule affording protection to disclosed assumptions should not be interpreted to create a negative inference that disclosure of forward-looking information without accompanying disclosure of assumptions is not protected. That language was included in the rule to make it clear that the entire disclosure which is made is protected and to afford maximum incentive to the voluntary disclosure of assumptions.

14. As indicated in Release 33-5992, relationships between a reviewer and the issuer should, of course, be disclosed. It should be noted that the final rule does not, in any event, cover statements concerning the relationship between the issuer and an outside reviewer.

15. 15 U.S.C. 80a et seq.

Exchange Act reports directly or other information sources that reflect the information contained in such reports.

Although some commentators were of the view that there should be no company status limitations and that forward looking information may be particularly important in assessing new enterprises, some commentators did not object to conditioning the availability of the rule on the existence of a reporting history, at least as an initial step. However, many questioned the propriety of limiting the availability of the rule to reporting companies while suggesting in the Guides that the absence of a history of operations or experience in projecting need not preclude an issuer from preparing projections with a reasonable basis.[16]

The Commission has considered the views of the commentators and agrees that the safe harbor rule should be available to as many companies as possible. However, the Commission is also concerned that there be a sufficient informational context in which a projection can be assessed and evaluated by investors, analysts, and others. Accordingly, the Commission has determined to make the rule available to reporting companies and has expanded the availability of the rule to non-reporting companies who include forward-looking statements in registration statements filed under the Securities Act, such as first time registrants using Form S-1 or Form S-18.[17]

Statements made by such companies in registration statements, Exchange Act reports, annual reports to shareholders, and other documents filed with the Commission will be covered by the rule. The rule also will be available for disclosures or reaffirmations of these forward-looking statements made at subsequent times, provided, of course, that such disclosures or reaffirmations meet the standards of reasonable basis and good faith at the time they are subsequently disclosed or reaffirmed. Statements made outside of these documents will be covered by the rule only if they are included in documents filed with the Commission or, for those companies the securities of which are registered pursuant to Section 12 of the Exchange Act, in annual reports to shareholders meeting the requirements of Rule 14a-3(b) and (c) or Rule 14c-3(a) and (b) under the Exchange Act.[18]

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16. See Guides 62 and 5, paragraph 1, Securities Act Release No. 5992, 43 FR 53246, November 7, 1978.

17. 17 CFR 239.11 and 17 CFR 239.28 respectively. Absent voluntary or mandatory registration under Section 12 of the Exchange Act, 15 USC 781, first time registrants are not subject to the reporting provisions of that Act until their Securities Act registration statements have become effective. See Section 15(d) of the Exchange Act, 15 USC 780(d), and Rules 15d-11 and 15d-13 respectively.

18. Rules 14a-3(c) and 14c-3(b) under the Exchange Act (17 CFR 240.14a-3(c) and 240.14c-3(b) respectively) provide that annual reports to shareholders are not deemed to be "filed" with the Commission or subject to the liabilities of Section 18 of that Act except to the extent an issuer specifically requests that

The Commission believes that the inclusion of forward-looking statements in filed documents and annual reports will provide investors with a better framework for their analysis through the context of certified financial statements and other disclosures appearing in registration statements and reports. In addition, staff review of those documents and the liability provisions of the Securities Act with respect to registration statements will help to assure that disclosure of forward-looking information will be made with greater care.

In addition, linking the availability of the rule for statements made outside of filed documents to subsequent inclusion in such documents reflects the Commission's continuing concern regarding the selective disclosure of forward-looking information. The inclusion of forward-looking statements in these documents will promote greater accessibility to this information for all investors.

Duty to Correct

As indicated in Release 33-5992, the Commission reminded issuers of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, where management knows or has reason to know that its earlier statements no longer have a reasonable basis. With respect to forward-looking statements of material facts made in relation to specific transactions or events (such as proxy solicitations, tender offers, and purchases and sales of securities), there is an obligation to correct such statements prior to consummation of the transaction where they become false or misleading by reason of subsequent events which render material assumptions underlying such statements invalid. Similarly, there is a duty to correct where it is discovered prior to consummation of a transaction that the underlying assumptions were false or misleading from the outset.

Moreover, the Commission believes that, depending on the circumstances, there is a duty to correct statements made in any filing, whether or not the filing is related to a specified transaction or event, if the statements either have become inaccurate by virtue of subsequent events, or are later discovered to have been false and misleading from the outset, and the issuer knows or should know that persons are continuing to rely on all or any material portion of the statements.[19]

This duty will vary according to the facts and circumstances of

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it be treated as part of the proxy soliciting material or incorporates it by reference into the proxy statement.

19. *See, e.g., Ross* v. *A. H. Robins Co., Inc.*, CCH Fed. Sec. L. Rep. ¶96,737 (S.D.N.Y. 1979), *appeal pending,* (2d Cir. No. 79-7106) [annual reports and prospectuses], *SEC* v. *Shattuck Denn Mining Corp.*, 297 F. Supp. 470 (S.D.N.Y. 1968) (press release). *See also Fischer* v. *Kletz,* 226 F. Supp. 180 (S.D.N.Y. 1967) (accountant's failure to disclose subsequent finding of falsity in certified financial statements included in annual reports to shareholders and Form 10-K).

individual cases. For example, the length of time between the making of the statement and the occurrence of the subsequent event, as well as the magnitude of the deviation, may have a bearing upon whether a statement has become materially misleading.

Current Filings Requirement

Several commentators questioned the appropriateness of the proposed requirement that Exchange Act reporting companies must have filed all annual, periodic, and other reports under that Act in order to be eligible for the safe harbor rule. Some were concerned that an inadvertent or immaterial filing delay could operate to deprive a company of protection under the rule for a statement that may fully meet the substantive standards of the rule. In this connection, other commentators did not perceive a strong relationship between the preparation of forward-looking statements and currency of Exchange Act filings.

While the existence of current Exchange Act reports also will provide additional information with which to assess forward-looking statements, the Commission agrees that the availability of the safe harbor rule should not be dependent upon a technical or immaterial circumstance. Accordingly, it has determined not to adopt the requirement that reporting companies be current in all Exchange Act filings. However, in light of certified financial statements and other extensive disclosure contained in annual reports on Form 10-K [17 CFR 249.310] that could provide contextual information for evaluation of forward-looking statements, the rule requires that reporting companies must have filed their most recent Form 10-K in order to be eligible for the safe harbor. Although no other requirement for currency of Exchange Act filings is adopted, the Commission believes that serious delinquency in filing or deficiency in content of Exchange Act filings may significantly impair a registrant's ability to prepare and disclose forward-looking statements with a reasonable basis.

Investment Companies

Those commentators who addressed the investment company issue expressed mixed views regarding the advisability of including investment companies in the safe-harbor rule. Some commentators did not perceive a basis for distinguishing between investment companies and other issuers and believed that the standard of reasonableness and good faith should be the appropriate benchmark for all companies.

Other commentators believed that the type of information generated by investment companies would be more difficult to forecast with reliability and is dependent upon market factors and responses to market events that are inherently unpredictable.

While the Commission does not believe that investment companies by definition are not capable of preparing reasonably based projections capable of disclosure in an appropriate format, it is of the view that the nature of information reported by investment companies is sufficiently distinct to warrant separate consideration. Accordingly, the Commission has determined not to extend the safe-harbor rule to investment company projections at this initial, experimental stage of its efforts to encourage disclosure of forward looking information. As experience is gained with disclosure of forward looking information by other companies, the Commission will consider whether an extension of the rule to investment companies is appropriate and whether separate guides for disclosure of projection by investment companies can be developed.

Effective Date and Operation

The rule will be effective for statements made on or after July 30, 1979. In view of the Commission's responsibility to protect investors and safeguard the public interest in connection with purchases and sales of securities, the adoption of these rules is in the nature of an experiment. The operation of the guides and the rules will be watched closely to limit their availability if the protection of investors so requires. The Commission anticipates that as the staff gains further experience with disclosure of forward-looking information, it will recommend the publication of such guidelines or interpretive releases on specific aspects of such disclosure in order to provide guidance to issuers.

Authority

The Commission is adopting the rules pursuant to its authority under Section 19(a) of the Securities Act of 1933 (15 U.S.C. 77s(a)), Sections 3(b) and 23(a)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78c and 78w(a)(1)), Section 20 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79t), and Section 319(a) of the Trust Indenture Act of 1939 (15 U.S.C. 77sss(a)). In addition to the definitional authority provided therein, Section 19(a) of the Securities Act, Section 23(a)(1) of the Exchange Act, Section 20(d) (15 U.S.C. 79t(d)) of the Holding Company Act and Section 319(c) of the Trust Indenture Act (15 U.S.C. 77sss(c)) provide that no liability under these acts "shall apply to any act done or omitted in good faith in conformity," with any rule or regulation of the Commission notwithstanding that such rule or regulation may later be amended, rescinded or determined invalid.

Pursuant to Section 23(a)(2) of the Exchange Act (15 U.S.C. 78w(a)(2)), the Commission has considered the effect that the rules would have on competition and is not aware at this time of any burden that the rules would impose on competition not necessary or appropriate in furtherance of the purposes of that Act.

Text of the Rules

Title 17 of the Code of Federal Regulations is amended by adding the following sections to parts 230, 240, 250 and 260.

Part 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933 §230.175. Liability for forward-looking statements by issuers.

(a) A statement within the coverage of paragraph (b) below which is made by or on behalf of an issuer or by an outside reviewer retained by the issuer shall be deemed not to be a fraudulent statement (as defined in paragraph (d) below), unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith.

(b) This rule applies to (1) a forward looking statement (as defined in paragraph (c) below) made in a document filed with the Commission or in an annual report to shareholders meeting the requirements of Rules 14a-3(b) and (c) or 14c-3(a) and (b) under the Securities Exchange Act of 1934, (2) a statement reaffirming the forward looking statement referred to in (b)(1) subsequent to the date the document was filed or the annual report was made publicly available, or (3) a forward looking statement made prior to the date the document was filed or the date the annual report was made publicly available if such forward looking statement is reaffirmed in a filed document or annual report made publicly available within a reasonable time after the making of such forward looking statement.

(c) For the purpose of this rule the term "forward looking statement" shall mean and shall be limited to:

(1) a statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;

(2) a statement of management's plans and objectives for future operations;

(3) a statement of future economic performance contained in management's discussion and analysis of the summary of earnings (as called for by Guides 22 and 1 under the Securities Act of 1933 and the Securities Exchange Act of 1934 and by instruction 5 to the Quarterly Report on Form 10-Q); or

(4) disclosed statements of the assumptions underlying or relating to any of the statements described in (1), (2), or (3) above.

(d) For the purpose of this rule the term "fraudulent statement" shall mean a statement which is an untrue statement of a material fact, a statement false or misleading with respect to any material fact, an omission to state a material fact necessary to make a statement not misleading, or which constitutes the employment of a manipulative, deceptive, or fraudulent device, contrivance, scheme, transaction, act, practice, course of business, or an artifice to defraud, as those terms are used in the Securities Act of 1933 or the rules or regulations promulgated thereunder.

(e) Notwithstanding any of the provisions of paragraphs (a) through (d), this rule shall apply only to forward looking statements made by or on behalf of an issuer if, at the time such statements are made or reaffirmed, the issuer is subject to the reporting requirements of the Securities Exchange Act of 1934 and has filed its most recent annual report on Form 10-K, or, if the issuer is not subject to the reporting requirements of the Securities Exchange Act of 1934, the statements are made in a registration statement filed under the Securities Act of 1933.

(f) Notwithstanding any of the provisions of paragraphs (a) through (e), this rule does not apply to statements made by or on behalf of an issuer that is an investment company registered under the Investment Company Act of 1940.

Part 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

§ 240.3b-6 Projections of future economic performance by issuers.

(The text of the rule is identical to that above except that reference to the Securities Act of 1933 in paragraph (d) should read "Securities Exchange Act of 1934.")

§240.14a-9 False or misleading statements.

* * * * *

NOTE: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this section.

(a) Predictions as to specific future market values.

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Part 250—GENERAL RULES AND REGULATIONS, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

§250.103A Projections of future economic performance by issuers.

(The text of the rule is identical to that above except that reference to the Securities Act of 1933 in paragraph (d) should read "Public Utility Holding Company Act of 1935 and other acts referred to in Section 16(b) thereof.")

Part 260—GENERAL RULES AND REGULATIONS, TRUST INDENTURE ACT OF 1939

§260.0-11 Projections of future economic performance by issuers.

(The text of the rule is identical to that above except that reference to the Securities Act of 1933 in paragraph (d) should read "Trust Indenture Act of 1939 and other acts referred to in Section 323(b) thereof.")

[secs. 19(a), 3(b), 23(a)(1), 20, 319(a), 48 Stat. 85, 882, 901; sec. 209, 48 Stat. 908; 49 Stat. 833; sec. 203(a), 49 Stat. 704; sec. 8, 49 Stat. 1379; 53 Stat. 1173; secs. 3, 18, 89 Stat. 97, 155; sec. 308(a)(2), 90 Stat. 57; 15 U.S.C. 77s(a), 78c(b), 78w(a)(1), 79t, 77sss(c)].

By the Commission.

George A. Fitzsimmons
Secretary

Appendix D

IRS REGULATIONS REGARDING TAX SHELTER OPINIONS (Circular 230)

DEPARTMENT OF THE TREASURY
Internal Revenue Service

31 CFR Part 10

Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service

AGENCY: Department of the Treasury.
ACTION: Final rule.

SUMMARY: This document contains final regulations governing practice before the Internal Revenue Service (IRS) to set standards for providing opinions used in the promotion of tax shelter offerings. The final regulations reflect the Treasury Department's concern about the proliferation of abusive tax shelters in recent years and the role of the IRS practitioner's opinion in the promotion of such shelters. The regulations address the problem by imposing duties upon IRS practitioners who furnish opinions for use in connection with tax shelter offerings.

DATES: These final regulations are effective with respect to tax shelter opinions provided after May 23, 1984.

FOR FURTHER INFORMATION CONTACT:
Mr. Leslie S. Shapiro, Director of Practice, Department of the Treasury, Washington, D.C. 20220, (202) 634-5135 (non toll free).

SUPPLEMENTARY INFORMATION:

Background

On September 4, 1980, the Federal Register (45 FR 58594) published for public comment a proposed rule that would amend the regulations governing practice before the IRS contained in 31 CFR, Part 10 (Treasury Department Circular No. 230). Among other things, the proposed rule would have required an IRS practitioner to comply with certain standards when providing a tax shelter opinion.

In addition, on November 17, 1980, the Federal Register (45 FR 75835) published a notice inviting comments from the public on the desirability of establishing an advisory committee to advise the Treasury Department on issues arising out of the standards proposed in the regulations for tax shelter opinions.

On January 29, 1982, the American Bar Association (ABA) issued a revised Formal Opinion 346 relating to the obligations of an attorney in issuing a tax shelter opinion. Unless otherwise noted, references herein to "ABA Opinion 346" refer to the Opinion in its revised form.

On December 15, 1982, a modified proposed rule was published in the Federal Register (47 FR 56144) (hereinafter referred to as the "proposed rule") which substantially modified the 1980 proposal in order to follow standards more nearly consistent with those set forth in ABA Opinion 346. The proposed rule required a practitioner who renders a tax shelter opinion to exercise responsibility with respect to the accuracy of the relevant facts; apply the law to the particular facts of the tax shelter offering; ascertain that all material Federal tax issues have been considered; where possible, provide an opinion as to the likely outcome on the merits of each material tax issue; provide an evaluation of the extent to which the material tax benefits in the aggregate will be realized; and assure that the nature and extent of the tax shelter opinion is described correctly in the offering materials.

Approximately fifteen written comments on the proposed rule were received from bar associations, accounting groups, individual attorneys, and accountants. After consideration of all comments regarding the proposed rule, it is hereby adopted as modified for clarification.

Explanation of Changes

The final rule adopted herein continues to follow the general guidelines of ABA Opinion 346, as did the proposed rule, and the "Supplementary Information" contained in the December 15, 1982, Notice of Proposed Rulemaking. However, various changes of a clarifying and stylistic nature have been made in the final rule. The more important changes, and the reasons for not making certain other suggested changes, are discussed below.

General Comments

A number of comments were received which generally supported the proposed rule, while others suggested that the proposed rule should be withdrawn. Some of the reasons given to withdraw the proposal included the contention that the proposed rule exceeded Treasury's statutory authority; that the rule is unnecessary in light of the publication of ABA Opinion 346 and recent statutory provisions directed at tax shelters added to the tax law; and that it would have little effect on persons who wish to participate in abusive tax shelters.

Treasury determined that the proposed rule should be finalized for several reasons. First, the legal profession has, by publication of ABA

Opinion 346, recognized that attorneys have unique ethical responsibilities when they render tax shelter opinions to persons who are not their clients. This action by the ABA reinforces Treasury's belief that tax practitioners must meet minimum standards of conduct with respect to tax shelter opinions, and that those who do not may be subject to suspension or disbarment from practice before Treasury.

Treasury has independent statutory authority to discipline incompetent and unethical conduct by practitioners,[1] while the ABA lacks such authority. State regulatory bodies may choose not to exercise their authority to regulate tax shelter opinions, or they may fail to follow uniform regulatory standards. In addition, certified public accountants, enrolled agents and enrolled actuaries also may practice before the IRS. For these reasons, action by Treasury is needed.

Finally, rules relating to tax shelter opinions complement the new penalties and other tax law changes made by Congress relating to tax shelters. For example, the new penalty for substantial understatements of tax liability under Internal Revenue Code section 6661 has increased the significance of determining whether there is sufficient legal authority for a position taken on a tax return. Thus, it is even more important than before that a prospective investor receive accurate and complete tax advice in the opinion as to the merits of the tax shelter offering. The final rule should help to improve the quality of this advice.

However, the regulations in this final rule are not intended to preclude local law and regulation from governing the preparation, issuance and dissemination of tax shelter opinions. However, regardless of the existence of local authority on the subject, the tax practitioner must observe and comply with the Treasury Department's regulations in order to avoid Treasury sanctions for misconduct thereunder.

Several commenters requested clarification of Treasury's position regarding "negative opinions" as set forth in the Supplementary Information accompanying the proposed rule. The final rule does not prohibit negative opinions, provided that all of the other requirements of the tax shelter

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1. 31 U.S.C. 330(b), relating to suspension or disbarment from practice before Treasury, provides:

(b) After notice and opportunity for a proceeding, the Secretary [of the Treasury] may suspend or disbar from practice before the Department [of the Treasury] a representative who—

(1) Is incompetent;
(2) Is disreputable;
(3) Violates regulations prescribed under this section; or
(4) With intent to defraud, willfully and knowingly misleads or threatens the person being represented or a prospective person to be represented.

opinion rules are met. However, it should be noted that a negative opinion may subject a practitioner to discipline under the final rule if it is not correctly, fairly and clearly described in the offering materials.

Specific Comments

1. *Due Diligence as to Factual Matters*

The proposed rule required a practitioner to exercise a degree of diligence with respect to the accuracy of factual matters relevant to a tax shelter opinion. Several comments stated that the proposed rule of this subject was unclear as to the scope of the practitioner's responsibility to verify the facts.

The Supplementary Information for the proposed rule stated that the applicable standards in this area generally were the same as those set forth in ABA Formal Opinion 346 and ABA Formal Opinion 335 (dealing with assumed fact opinions in connection with sale of unregistered securities). The final rule has been modified to incorporate a statement of the appropriate standards directly into the rule. Section 10.33(a)(1) now provides that a practitioner generally need not conduct an independent verification of the facts unless he knows, or should know, that the facts provided to him by the promoter or another person are untrue. Furthermore, a practitioner may accept without further inquiry an asserted valuation of property, an appraisal, or a projection, as support for the matters claimed therein only if they make sense on their face, and, in the case of an appraisal or projection, the practitioner reasonably believes that the person providing the appraisal or projection is competent to do so. Finally, if a valuation of purchased property is based on its stated purchase price, the practitioner must examine the circumstances surrounding the purchase to determine whether the stated purchase price reasonably may be considered to be the fair market value of the property.

2. *Opinion on Each Material Tax Issue*

Under the proposed rule, practitioners were required to render an opinion on each material tax issue in the offering. The final rule clarifies that an opinion is necessary only with respect to material issues that involve a reasonable possibility of a challenge by the IRS.

Under the rule, opinions are required only "where possible." Treasury will give cases in which practitioners conclude that opinions are not possible special scrutiny to prevent recurrence of the practice of rendering tax shelter "opinions" that do not truly express any opinion at all. Such "opinions" may be sued to mislead investors, who may believe that the practitioner's participation in the shelter offering is an endorsement of the shelter.

3. Overall Evaluation

The proposed rule required a practitioner to make an overall evaluation of the extent to which the tax benefits of the tax shelter in the aggregate were likely to be realized. The final rule has been clarified to provide that such an overall opinion need be rendered only where it is possible to do so. As with opinions on material tax issues, Treasury expects that it will be possible to render an overall evaluation in the great majority of cases (a view shared by ABA Opinion 346).

The final rule specifically requires that the existence of an unfavorable overall evaluation, or an opinion that concludes that an overall evaluation is not possible, must clearly be disclosed in the offering materials.

One comment suggested that reference to "aggregate" tax benefits is ambiguous since no guidelines were provided for making the evaluation. The final rule clarifies the purported ambiguity by defining a favorable overall evaluation as one concluding that substantially more than half of the material tax benefits of the tax shelter, in terms of their financial impact on a typical investor, more likely than not will be realized. Any other conclusion should be viewed as a less than favorable overall evaluation and should be set forth prominently in the opinion as such. Further, several examples of how the overall evaluation requirement is to be applied in typical tax shelter situations are provided.

4. Partial Opinions

The proposed rule permitted a practitioner to render an opinion on less than all the material tax issues if certain conditions were met. In particular, a partial opinion could be given only if the practitioner had no reason to believe that the overall evaluation of the tax shelter provided by another practitioner was incorrect.

Several comments expressed concern that the duty to examine the correctness of the overall evaluation is unduly burdensome to a practitioner hired to render only a partial opinion. The proposed rule was not intended to impose unreasonable burdens on practitioners who give partial opinions. The final rule now provides that the practitioner giving the partial opinion must have no reason to believe that the overall evaluation is incorrect on its face. It is anticipated that practitioners will meet this requirement by reviewing the overall evaluation to determine if it makes sense on its face, based on the practitioner's knowledge and experience, and if it is internally consistent with the opinions rendered on each material tax issue of the shelter.

In addition, comments by certified public accountants have requested clarification of the applicability of the final rule to practitioners who are associated with financial forecasts or projections included in tax shelter offering materials. The final rule states that practitioners who provide such forecasts or projections must comply with the general rules applicable to partial tax shelter opinions.

Financial forecasts or projections often include assumptions as to the tax return reporting positions to be taken with respect to material tax issues. Tax shelter forecasts or projections therefore could mislead investors by implicitly suggesting that the tax return positions they reflect are proper. For this reason, the final rule treats forecasts or projections involving any tax assumptions as "tax shelter" opinions. If the forecasts or projections themselves do not address all of the material tax issues in the required manner, all material tax issues that form the basis for such forecasts or projections must be fully addressed by the practitioner or some other practitioner in a tax opinion (or elsewhere in the offering materials) that meets the criteria set forth in the rules. Furthermore, the practitioner associated with the forecasts or projections will be responsible for rendering an opinion on any material tax issue not addressed in the tax opinion by the other practitioner. Finally, the nature and extent of the forecasts or projections must be described correctly in the offering materials.

5. *Definitions*

The definition of a tax shelter generated the greatest number of comments. Some comments suggested that the definition used (patterned after that in ABA Opinion 346) was overbroad, and that it should be made consistent with the definition of a tax shelter in Internal Revenue Code section 6661 (penalty for substantial understatements of tax liability). The final rule does not incorporate this suggestion because section 6661 is intended to identify a relatively narrow category of transactions that should be subject to more stringent penalty requirements because their principal purpose is tax avoidance. In contrast, the tax shelter opinion rules serve a different purpose. Merely because an investment has a business or profit objective and is not principally tax motivated does not mean that it does not also have substantial tax shelter features in the eyes of potential investors, or that a full and complete tax opinion is not necessary.

The tax shelter definition in the final rule provides that the tax shelter effect of a transaction must be both substantial and intended. The reason for this modification is to avoid "retroactive" reclassification of an investment as a tax shelter if unintended losses exceed income in a year (for example, when an unsuccessful investment is disposed of or terminated). The offering materials will be given significant weight to determine whether tax shelter benefits are an intended result of the transaction.

The tax shelter definition also was modified to negate an erroneous interpretation by some that real estate investments are not considered tax shelters unless they produce tax losses in every year. If net losses are foreseeable in *any* year, a real estate investment is a tax shelter. The exclusion from the tax shelter definition for "family trusts" also was amended so that it applied only to family trusts provided in direct practitioner–client relationships, and not to trust schemes that are publicly marketed by promoters.

The definition of "tax shelter opinion" was changed to clarify the fact that an opinion letter or a tax description in a tax shelter offering circular is a tax shelter opinion even if the practitioner's name is not used.

6. Disciplinary Standards, Firm Opinions

In response to several comments, the standards of culpability required to discipline a practitioner for failing to comply with the tax shelter opinion rules or the prohibition against false opinions have been conformed. A violation of the tax shelter opinion rules or the rule relating to false opinions will be subject to discipline if the practitioner violates the rules willfully (or knowingly), recklessly, through gross incompetence, or if the violation is part of a pattern of repeated violations.

The proposed rule provided that in certain circumstances an entire firm could be disciplined for firm opinions that violated the tax shelter opinion standards. In light of comments pointing to the difficulty of imposing sanctions on firms rather than on individual practitioners, this provision has been deleted from the final rule.

7. Advisory Committee

The provision authorizing formation of an Advisory Committee for the Director of Practice has been modified to provide that action by the Committee is to be taken at the request of the Director of Practice.

One comment questioned the ability of the Director of Practice to enforce the tax shelter opinion rules in an impartial manner. Although the Director of Practice is now an official of the Internal Revenue Service, assessment of individual cases is made on an independent basis. Further, the administrative and judicial appeals described in the Supplementary Information accompanying the proposed rule continue to be applicable to disciplinary actions. Treasury believes that these safeguards are sufficient to assure that the tax shelter opinion rules will be administered in a fair and equitable manner.

8. Return Preparation

In order to clarify § 10.7 of the regulations, the heading is being changed to address its full scope.

Executive Order 12291

It has been determined that this rule is not a major rule as defined in Executive Order 12291. This rule relates solely to practice before the IRS and is not expected to have any significant economic consequences.

Regulatory Flexibility Act

This rule is not subject to the provisions of the Regulatory Flexibility Act since the initial Notice of Proposed Rulemaking was published before January 1, 1981, the effective date of the Act.

Drafting Information

The principal author of these regulations is Mr. Leslie S. Shapiro, Director of Practice, Department of the Treasury. Other present and former personnel in the Treasury Department participated in the development of the regulations, both as to substance and style.

List of Subjects in 31 CFR Part 10

Administrative rules and procedures, Lawyers, Accountants, Enrolled agents, and Enrolled actuaries.

Authority: These final rules are issued under authority of Sec. 3, 23 Stat. 258, Secs. 2-12, 60 Stat. 237 et seq.; 5 U.S.C. 301; 31 U.S.C. 330; 31 U.S.C. 321 (Reorg. Plan No. 26 of 1950. 15 FR 4935, 64 Stat. 1280, 3 CFR, 1940-53 Comp., p. 1017).

Adoption of Amendments to Regulations

Accordingly, 31 CFR Part 10 is amended as follows:

§ 10.2 [Amended]

1. In § 10.2, paragraph (a) is amended by removing the third sentence.
2. Section 10.7 is amended by revising the heading and by adding paragraph (c), to read as follows:

§ 10.7 Limited practice; special appearances; return preparation and furnishing information.

. . . .

(c) *Preparation of tax returns and furnishing information.* Any person may prepare a tax return, may appear as a witness for the taxpayer before the Internal Revenue Service, or furnish information at the request of the Internal Revenue Service or any of its officers or employees.

3. Section 10.33 is added to read as follows:

§ 10.33 Tax shelter opinions.

(a) *Tax shelter opinions and offering materials.* A practitioner who provides a tax shelter opinion analyzing the Federal tax effects of a tax shelter investment shall comply with each of the following requirements:

(1) *Factual matters.* (i) The practitioner must make inquiry as to all

relevant facts, be satisfied that the material facts are accurately and completely described in the offering materials, and assure that any representations as to future activities are clearly identified, reasonable and complete.

(ii) A practitioner may not accept as true asserted facts pertaining to the tax shelter which he/she should not, based on his/her background and knowledge, reasonably believe to be true. However, a practitioner need not conduct an audit or independent verification of the asserted facts, or assume that a client's statement of the facts cannot be relied upon, unless he/she has reason to believe that any relevant facts asserted to him/her are untrue.

(iii) If the fair market value of property or the expected financial performance of an investment is relevant to the tax shelter, a practitioner may not accept an appraisal or financial projection as support for the matters claimed therein unless:

(A) The appraisal or financial projection makes sense on its face;

(B) The practitioner reasonably believes that the person making the appraisal or financial projection is competent to do so and is not of dubious reputation; and

(C) The appraisal is based on the definition of fair market value prescribed under the relevant Federal tax provisions.

(iv) If the fair market value of purchased property is to be established by reference to its stated purchase price, the practitioner must examine the terms and conditions upon which the property was (or is to be) purchased to determine whether the stated purchase price reasonably may be considered to be its fair market value.

(2) *Relate law to facts.* The practitioner must relate the law to the actual facts and, when addressing issues based on future activities, clearly identify what facts are assumed.

(3) *Identification of material issues.* The practitioner must ascertain that all material Federal tax issues have been considered, and that all of those issues which involve the reasonable possibility of a challenge by the Internal Revenue Service have been fully and fairly addressed in the offering materials.

(4) *Opinion on each material issue.* Where possible, the practitioner must provide an opinion whether it is more likely than not that an investor will prevail on the merits of each material tax issue presented by the offering which involves a reasonable possibility of a challenge by the Internal Revenue Service. Where such an opinion cannot be given with respect to any material tax issue, the opinion should fully describe the reasons for the practitioner's inability to opine as to the likely outcome.

(5) *Overall evaluation.* (i) Where possible, the practitioner must provide an overall evaluation whether the material tax benefits in the aggregate more likely than not will be realized. Where such an overall evaluation

cannot be given, the opinion should fully describe the reasons for the practitioner's inability to make an overall evaluation. Opinions concluding that an overall evaluation cannot be provided will be given special scrutiny to determine if the stated reasons are adequate.

(ii) A favorable overall evaluation may not be rendered unless it is based on a conclusion that substantially more than half of the material tax benefits, in terms of their financial impact on a typical investor, more likely than not will be realized if challenged by the Internal Revenue Service.

(iii) If it is not possible to give an overall evaluation, or if the overall evaluation is that the material tax benefits in the aggregate will not be realized, the fact that the practitioner's opinion does not constitute a favorable overall evaluation, or that it is an unfavorable overall evaluation, must be clearly and prominently disclosed in the offering materials.

(iv) The following examples illustrate the principles of this paragraph:

Example (1). A limited partnership acquires real property in a sale–leaseback transaction. The principal tax benefits offered to investing partners consist of depreciation and interest deductions. Lesser tax benefits offered to investors by reason of several deductions under Internal Revenue Code section 162 (ordinary and necessary business expenses). If a practitioner concludes that it is more likely than not that the partnership will not be treated as the owner of the property for tax purposes (which is required to allow the interest and depreciation deductions), then he/she may not opine to the effect that it is more likely than not that the material tax benefits in the aggregate will be realized, regardless of whether favorable opinions may be given with respect to the deductions claimed under Code section 162.

Example (2). A corporation electing under subchapter S of the Internal Revenue Code is formed to engage in research and development activities. The offering materials forecast that deductions for research and experimental expenditures equal to 75% of the total investment in the corporation will be available during the first two years of the corporation's operations, other expenses will account for another 15% of the total investment, and that little or no gross income will be received by the corporation during this period. The practitioner concludes that it is more likely than not that deductions for research and experimental expenditures will be allowable. The practitioner may render an opinion to the effect that based on this conclusion, it is more likely than not that the material tax benefits in the aggregate will be realized, regardless of whether he/she can opine that it is more likely than not that any of the other tax benefits will be achieved.

Example (3). An investment program is established to acquire offsetting positions in commodities contracts. The objective of the program is to close the loss positions in year one and to close the profit positions in year two. The principal tax benefit offered by the program is a loss in the first year, coupled with the deferral of offsetting gain until the following year. The practitioner concludes that the losses will not be deductible in year one. Accordingly, he/she may not render an opinion to the effect that it is more likely than not that the material tax benefits in the aggregate will be realized, regardless of the fact that he/she is of the opinion that losses not allowable in year one will be allowable in year two, because the principal tax benefit offered is a one-year deferral of income.

Example (4). A limited partnership is formed to acquire, own and operate residential rental real estate. The offering material forecasts gross income of $2,000,000 and total deductions of $10,000,000, resulting in net losses of $8,000,000 over the first six taxable years. Of the total deductions, depreciation and interest are projected to be $7,000,000, and other deductions $3,000,000. The practitioner concludes that it is more likely than not that all of the depreciation and interest deductions will be allowable, and that it is more likely than not that the other deductions will not be allowed. The practitioner may render an opinion to the effect that it is more likely than not that the material tax benefits in the aggregate will be realized.

(6) *Description of opinion.* The practitioner must assure that the offering materials correctly and fairly represent the nature and extent of the tax shelter opinion.

(b) *Reliance on other opinions*—(1) *In general.* A practitioner may provide an opinion on less than all of the material tax issues only if:

(i) At least one other competent practitioner provides an opinion on the likely outcome with respect to all of the other material tax issues which involve a reasonable possibility of challenge by the Internal Revenue Service, and an overall evaluation whether the material tax benefits in the aggregate more likely than not will be realized, which is disseminated in the same manner as the practitioner's opinion; and

(ii) The practitioner, upon reviewing such other opinions and any offering materials, has no reason to believe that the standards of paragraph (a) of this section have not been complied with. Notwithstanding the foregoing, a practitioner who has not been retained to provide an overall evaluation whether the material tax benefits in the aggregate more likely than not will be realized may issue an opinion on less than all the material tax issues only if he/she has no reason to believe, based on his/her knowledge and experience, that the overall evaluation given by the practitioner who furnishes the overall evaluation is incorrect on its face.

(2) *Forecasts and projections.* A practitioner who is associated with forecasts or projections relating to or based upon the tax consequences of the tax shelter offering that are included in the offering materials, or are disseminated to potential investors other than the practitioner's clients, may rely on the opinion of another practitioner as to any or all material tax issues, provided that the practitioner who desires to rely on the other opin-

ion has no reason to believe that the standards of paragraph (a) of this section have not been complied with by the practitioner rendering such other opinion, and the requirements of paragraph (b)(1) of this section are satisfied. The practitioner's report shall disclose any material tax issue not covered by, or incorrectly opined upon, by the other opinion, and shall set forth his/her opinion with respect to each such issue in a manner that satisfies the requirements of paragraph (a) of this section.

(c) *Definitions.* For purposes of this section:

(1) "Practitioner" is any person authorized under § 10.3 of this part to practice before the Internal Revenue Service.

(2) A "tax shelter," as the term is used in this section, is an investment which has as a significant and intended feature for Federal income or excise tax purposes either of the following attributes. (i) Deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, or (ii) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year. Excluded from the term are municipal bonds; annuities; family trusts (but not including schemes or arrangements that are marketed to the public other than in a direct practitioner–client relationship); qualified retirement plans; individual retirement accounts, stock option plans; securities issued in a corporate reorganization; mineral development ventures, if the only tax benefit would be percentage depletion; and real estate where it is anticipated that in no year is it likely that deductions will exceed the tax attributable to the income from the investment in that year. Whether an investment is intended to have tax shelter features depends on the objective facts and circumstances of each case. Significant weight will be given to the features described in the offering materials to determine whether the investment is a tax shelter.

(3) A "tax shelter opinion," as the term is used in this section, is advice by a practitioner concerning the Federal tax aspects of a tax shelter either appearing or referred to in the offering materials, or used or referred to in connection with sales promotion efforts, and directed to persons other than the client who engaged the practitioner to give the advice. The term includes the tax aspects or tax risks portion of the offering materials prepared by or at the direction of a practitioner, whether or not a separate opinion letter is issued or whether or not the practitioner's name is referred to in the offering materials or in connection with the sales promotion efforts. In addition, a financial forecast or projection prepared by a practitioner is a tax shelter opinion if it is predicated on assumptions regarding Federal tax aspects of the investment, and it meets the other requirements of the first sentence of this subparagraph. The term does not, however, include rendering advice solely to the offeror or reviewing parts of the

offering materials, so long as neither the name of the practitioner, nor the fact that a practitioner has rendered advice concerning the tax aspects, is referred to in the offering materials or in connection with the sales promotion efforts.

(4) A "material" tax issue as the term is used in this section is (i) any Federal income or excise tax issue relating to a tax shelter that would make a significant contribution toward sheltering from Federal taxes income from other sources by providing deductions in excess of the income from the tax shelter investment in any year, or tax credits available to offset tax liabilities in excess of the tax attributable to the tax shelter investment in any year; (ii) any other Federal income or excise tax issue relating to a tax shelter that could have a significant impact (either beneficial or adverse) on a tax shelter investor under any reasonably foreseeable circumstances (e.g., depreciation or investment tax credit recapture, availability of long-term capital gain treatment, or realization of taxable income in excess of cash flow, upon sale or other disposition of the tax shelter investment); and (iii) the potential applicability of penalties, additions to tax, or interest charges that reasonably could be asserted against a tax shelter investor by the Internal Revenue Service with respect to the tax shelter. The determination of what is material is to be made in good faith by the practitioner, based on information available at the time the offering materials are circulated.

4. Section 10.51 is amended by adding new paragraph (j) to read as follows:

§ 10.51 Disreputable conduct.

. . . .

(j) Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or a pattern of providing incompetent opinions on questions arising under the Federal tax laws. False opinions described in this paragraph include those which reflect or result from a knowing misstatement of fact or law; from an assertion of a position known to be unwarranted under existing law; from counseling or assisting in conduct known to be illegal or fraudulent; from concealment of matters required by law to be revealed; or from conscious disregard of information indicating that material facts expressed in the tax opinion or offering material are false or misleading. For the purpose of this paragraph, reckless conduct is a highly unreasonable omission or misrepresentation, involving not merely simple or inexcusable negligence, but an extreme departure from the standards of ordinary care that is either known or is so obvious that the competent practitioner must or should have been aware of it. Gross incompetence includes conduct that reflects gross indifference, preparation which is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.

5. In § 10.52, (a) introductory text is added, the rest of the existing paragraph is designated as paragraph (a), and new paragraph (b) is added to read as follows:

§ 10.52 Violation of regulations.

(a) *In General*. . . .

(b) *Tax shelter opinions*. An attorney, certified public accountant, enrolled agent or enrolled actuary may be disbarred or suspended from practice before the Internal Revenue Service for violating any part of § 10.33 of this part, if such violation is willfull, reckless or through gross incompetence (within the meaning of § 10.51(j) of this part); or if the violation is part of a pattern of providing tax shelter opinions that fail to comply with § 10.33 of this part.

6. Section 10.76 is added to read as follows:

§ 10.76 Advisory committee.

For purposes of advising the Director of Practice whether an individual may have violated § 10.33 of this part, the Director of Practice is authorized to establish an Advisory Committee, composed of at least five individuals authorized to practice before the Internal Revenue Service. Under procedures established by the Director of Practice, such Advisory Committee shall, at the request of the Director of Practice, review and make recommendations with regard to alleged violations of § 10.33 of this part.

Dated: February 14, 1984.

Peter J. Wallison,

General Counsel, Department of the Treasury.